

ACRP

REPORT 36

Airport/Airline Agreements— Practices and Characteristics

**AIRPORT
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ACRP REPORT 36

**Airport/Airline Agreements—
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AIRPORT COOPERATIVE RESEARCH PROGRAM

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The need for ACRP was identified in *TRB Special Report 272: Airport Research Needs: Cooperative Solutions* in 2003, based on a study sponsored by the Federal Aviation Administration (FAA). The ACRP carries out applied research on problems that are shared by airport operating agencies and are not being adequately addressed by existing federal research programs. It is modeled after the successful National Cooperative Highway Research Program and Transit Cooperative Research Program. The ACRP undertakes research and other technical activities in a variety of airport subject areas, including design, construction, maintenance, operations, safety, security, policy, planning, human resources, and administration. The ACRP provides a forum where airport operators can cooperatively address common operational problems.

The ACRP was authorized in December 2003 as part of the Vision 100-Century of Aviation Reauthorization Act. The primary participants in the ACRP are (1) an independent governing board, the ACRP Oversight Committee (AOC), appointed by the Secretary of the U.S. Department of Transportation with representation from airport operating agencies, other stakeholders, and relevant industry organizations such as the Airports Council International-North America (ACI-NA), the American Association of Airport Executives (AAAE), the National Association of State Aviation Officials (NASAO), and the Air Transport Association (ATA) as vital links to the airport community; (2) the TRB as program manager and secretariat for the governing board; and (3) the FAA as program sponsor. In October 2005, the FAA executed a contract with the National Academies formally initiating the program.

The ACRP benefits from the cooperation and participation of airport professionals, air carriers, shippers, state and local government officials, equipment and service suppliers, other airport users, and research organizations. Each of these participants has different interests and responsibilities, and each is an integral part of this cooperative research effort.

Research problem statements for the ACRP are solicited periodically but may be submitted to the TRB by anyone at any time. It is the responsibility of the AOC to formulate the research program by identifying the highest priority projects and defining funding levels and expected products.

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Valuable production assistance was provided by Natalie Leaman, Andrea Arnold and other members of the graphics design and production team at R&A. In addition, the input and guidance of ACRP staff and the ACRP Project 01-07 panel for this project are gratefully acknowledged.



FOREWORD

By **Michael R. Salamone**

Staff Officer

Transportation Research Board

ACRP Report 36: Airport/Airline Agreements—Practices and Characteristics provides an objective resource tool to assist both airport operators and airlines with negotiating and understanding various aspects related to airline/airport operator business relationships—including those in use and lease agreements—by enhancing mutual understanding of each other's decision-making process during negotiations. The report presents examples and material collected from many airports to help clarify the thought process and perspective of both airports and airlines during negotiations. Other industry stakeholders such as rating agencies, investment bankers, and financial advisors will also find this report informative and useful.

Under ACRP Project 01-07, Ricondo & Associates, Inc. was directed to examine the breadth of knowledge and variety of practices that exist in the airport industry guiding the relationships between airport operators and perhaps their most important tenant, the airline. Through survey, focus groups, workshops, and in-depth discussions, the research team engaged executives from both airport operators and airlines of various sizes and characteristics, conducted several focus groups, and interviewed dozens of frontline negotiators. Research helped gain insight into the more subjective and complex nature of airport/airline relationships that may be difficult to acquire through other means or a written survey. Interactive discussions provided valuable insight and perspectives related to agreement negotiations, the development of rate-setting approaches, and other critical issues associated with the overall business relationships between parties.



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PART I

WHY IS THERE A NEED FOR THIS MANUAL?

Introduction

This resource manual (the “Manual”) contains the results of the research efforts undertaken by the research team for the ACRP Project 01-07, “Airport/Airline Agreements and Rate Methodologies—Practices and Characteristics.” The introduction chapter explains the intent of the Manual and why this research effort was undertaken, the overall methodology employed, how this Manual should be used by both airport operators and airlines, and the overall organization of the Manual. It is important to note that this Manual is intended to be an objective resource tool, and no recommendations are provided about specific negotiation issues, provisions, or strategies. The material provided in this Manual is intended to assist both airport operators and airlines with negotiating and understanding various aspects related to airline/airport operator business relationships, including those in an Airport/Airline Use and Lease Agreement (“Agreement”), by providing sufficient information to enhance the decision-making process during negotiations. This Manual will also describe a business arrangement in the absence of an Agreement, as there are no legal obligations for the airlines or airport operators to enter into Agreements.

1.1 Intent and Purpose of the Manual

“I heard that Airport ‘X’ got (name the provision) in its Agreement. I want to make sure we get that in ours.”

“Our current Agreement expires in (‘x’ number of days). Can we get a new Agreement in place, and approved by our Board, before the expiration of the current Agreement?”

“I want to make sure our Agreement provides for us to maintain (‘x’ number of days) of operating cash, regardless of any other provisions we negotiate.”

“We airlines are OK with (name that provision) in your airport’s Agreement, but we are concerned with the precedent it will set in the industry.”

“We airlines would suggest you take the Agreement from (Airport ‘X’), as it is a well-run airport and they keep their airline costs low.”

“Despite the downturns in the economy, our capital program still makes sense over the long run, and we will need it approved under this new Agreement.”

The above questions and statements are frequently heard from both airport operators and airlines. It has been the experience of the research team that many desired outcomes in the very dynamic aviation industry are based, in part, on what others are doing or have already accomplished. While both airport operators and airlines want to be “state of the art” and “to think outside the box,” both parties rely a great deal on concepts that have been developed and validated through previous negotiations, and are, therefore, easier to get approved from the airport operator’s governing body and the airline’s senior management.

The airport industry has historically been a dynamic environment that is influenced by decisions made and actions taken by federal and local governments and regulatory agencies, airline policies and practices, airport capital development and improvement needs, the amount and nature of the demand for airline travel in each market, and worldwide economic conditions that vary by region, among other factors. Each airport operator, although constrained by laws, regulations, and management practices and policies, is essentially an independent decision maker continuously challenged with establishing a vision and a roadmap for the future amid a changing operating, regulatory, and political environment. In addition, **each airport is unique**. A general statement heard over the years is

“If you see one airport, you’ve seen one airport.”

On the other “side of the table” are the airlines. They are struggling with their own issues, many of which are not even airport-related. In the current economic environment, many airlines are in survival mode, merely trying to continue flying their aircraft and passengers from destination to destination while maintaining the cash flow necessary to operate. When the available resources to dedicate to product differentiation are limited, and passengers increasingly view an airline seat as a commodity, it is challenging for an airline to differentiate itself from competitors, and to be profitable while doing so. Controlling costs, both operating and capital, poses significant challenges for the airlines as they balance trying to limit increases in airport costs, while retaining access to the necessary facilities to support growth expectations at most airports.

Both the airport operators and the airlines have been and are still experiencing turbulent times. Both parties may believe that they have reached the outer limits of their ability to reduce their operating costs further. While some airport operators still believe that the airlines need them more than they need the airlines and vice versa—the airport/airline relationship is symbiotic. Therefore, formalization of the operating and financial framework in which both parties function becomes extremely important. Essentially, an Agreement defines the rights, responsibilities, and limitations of both parties throughout its term.

At the completion of the negotiations, it is important that both parties be able to answer the following questions satisfactorily:

- Did the airport operator and airlines achieve their respective primary goals and objectives within the context of an Agreement or business arrangement?
- Does the airport operator have the flexibility to undertake needed capital development?
- Are the rates and charges formulas fair, reasonable, and equitable to the airlines?
- Do the airlines operating at the airport have the appropriate facilities to operate their preferred flight schedule?
- Does the Agreement appropriately balance both risk and reward between the parties?
- Do both the airport operator and the airlines feel they benefit from the business relationship memorialized in the Agreement?
- Is the Agreement flexible enough to adapt to changing economic or other dynamic industry circumstances?

The primary intent of this Manual is to provide a tool to assist both airport operators and airlines during business arrangement negotiations by describing the range of business relationships between airports and airlines including the underlying rates and charges methodologies, presenting a general negotiation process and schedule, identifying key information for a negotiation, identifying the various issues that typically surface, describing the various alternatives for resolving potential conflicts and issues, and identifying the linkages among these various critical issues. It will be important for airport operators and airlines to learn from and understand what others have incorporated in their respective Agreements, but it will also be important for an airport operator to understand that **provisions in any agreement satisfy the needs of that particular airport setting, and are not being negotiated because they are in some other airport operator's agreement.** Meanwhile, it will be important for the airlines to understand that **provisions in a particular airport operator's agreement are intended for that particular airport setting, and are not intended to set a precedent for all new agreements.**

The information presented in this Manual is intended to assist both airport operators and airlines in gaining better awareness and understanding of what motivates the other party and why, to provide alternative approaches and options that may assist for resolving issues, and to share what other airport operators and airlines have experienced in previous negotiations. It will be important for readers of this Manual to understand that, **in many instances, there will not necessarily be right or wrong ways to resolve certain issues.** What is important is that the provisions negotiated are those that address and satisfy the needs of **that particular airport and the airlines operating there.** If this is understood, the Manual can be a valuable tool for the industry for years to come.

1.2 Study Methodology

The information contained in this Manual is based on research efforts conducted over the last 18 months and supplemented by the overall experience of the research team. The primary research efforts consisted of a relevant literature search, interviews and focus group sessions with industry stakeholders, online surveys for both airport operators and airlines, and a workshop with industry participants.

A comprehensive search of relevant industry literature, existing research, current regulatory requirements, significant litigation, existing Agreements, and other appropriate written material was performed. This information was gathered, reviewed, and analyzed for its applicability to the Manual. A completed annotated listing of all this material is contained in Appendix A.

To engage executives from both airport operators and airlines of various sizes and characteristics, several focus groups were developed and interviewed. The primary objective of the focus groups was to gain insight of a more subjective and complex nature that may be difficult to acquire through a formal written survey. Through interactive discussions with the research team, these focus groups provided valuable insight and perspectives related to Agreement negotiations, the development of rate-setting approaches, and other critical issues associated with the overall business relationships between parties. Interviews were also conducted with other industry stakeholders such as rating agencies, investment bankers, and financial advisors to gain their perspectives on Agreements.

On-line surveys were developed and distributed to both airport operators and airlines. The primary objective of the surveys was to obtain data and information of a more factual and less subjective nature from a large group of stakeholders. The on-line survey provided the basis for much of the factual data presented in this Manual.

In July 2009, the research team conducted a workshop to obtain feedback from the industry regarding the draft resource manual. Participants at this workshop included airport finance directors, airport executive directors, and airline property representatives. Also present were the members of the ACRP Project 01-07 panel. Information and feedback obtained from this workshop were reviewed and evaluated and, where appropriate, incorporated in the draft resource manual.

1.3 Organization and Structure of the Manual

This Manual is categorized into four main parts: (1) defining the need for this Manual, (2) providing guidance on how airlines and airport operators start and prepare for negotiations, (3) giving perspectives on various critical issues that can surface during airline/airport operator negotiations, and (4) providing an outlook on the future of Agreements and creative approaches for addressing various issues. Also, given the related nature of several airline/airport operator business arrangement issues and provisions, this Manual has also been developed to provide several cross-references and linkages among topics to guide the reader to the appropriate information for each topical area.

It is important to note that this Manual is intended to be an objective resource tool. No recommendations are provided about specific negotiation issues, provisions, or strategies. The primary objective of this Manual is to assist both airport operators and airlines with negotiating an Agreement by providing sufficient information to enhance the decision-making process during negotiations.

Background

This chapter describes the purpose of an Agreement. Also discussed is whether an Agreement is actually “needed,” and what alternative arrangements are available for airport operators and airlines to consider. The three primary types of underlying business arrangements or airline rate-setting methodologies inherent in Agreements are described along with examples of circumstances in which an airport operator and its airlines might consider a certain approach. The last section provides a brief history of the trends in business arrangements that have been negotiated in Agreements in recent years.

2.1 Purpose of Agreements

Basically, an Agreement is the contract between the airport operator and its tenant airlines that establishes the rights, privileges, and obligations for each party and defines how the airport is to be used by the airlines. In addition, an Agreement also provides the following:

- Establishes the business arrangement and rate-setting methodology with the airlines (e.g., compensatory, hybrid, residual);
- Identifies the premises and facilities leased by the airlines and defines the degree of control by the lessee (e.g., exclusively leased, preferentially leased, leased in common, etc.);
- Defines the level of control over the expenses at the airport, if any (typically capital expenses are those where the airlines may have some control through a majority-in-interest or similar-type provision); and
- Identifies general party responsibilities and obligations for indemnification, insurance, environmental issues, and other governmental inclusion.

In addition, an Agreement can also be viewed as beneficial because it symbolizes that the airport operator and airlines have worked together to arrive at a common business relationship. It is important to understand, however, that an Agreement approach may not always be the preferred business arrangement for an airport operator or an airline, nor is it a required approach. Several large and medium hub U.S. airports do not have an Agreement.

2.2 Non-Agreement Approach

The establishment of the business arrangement between the airlines and the airport operator without an Agreement is generally referred to as the “ordinance” approach (or, in some cases, a resolution, regulation, or tariff approach). In the absence of a negotiated contract, the local governing body for the airport will enact certain legislation, typically an ordinance that will state the conditions and terms under which airline tenants of an airport will operate. This legislation or ordinance will also set the airline fees and charges for use of the airport.

While an Agreement may be desired by certain airport operators and airlines as a method of entering into a business relationship, it is important to recognize that Agreements are not required by law. In the absence of an Agreement, airports can establish by ordinance, resolution, tariff, regulation or other unilateral action the local rules that will govern the airlines' use of their airport facilities. At a number of airports, rates and charges, rules controlling the use of terminal space, and other important terms and conditions for the use of the airport have been established in this way. In the absence of an Agreement, however, airlines serving an airport retain their right to challenge the legality of the terms and conditions imposed by the airport operator. The following are several examples of airports that currently operate without Agreements:

- Gerald R. Ford International Airport (Grand Rapids)
- Phoenix Sky Harbor International Airport
- Sacramento International Airport

As an established principle under the U.S. Department of Transportation's (U.S. DOT's) *Policy Regarding Airport Rates and Charges, June 19, 1996*,¹ an airport operator may not require the airlines to cover any financial losses it may experience in absence of an Agreement. Therefore, without an Agreement, the airport operator may only set fees and charges via a compensatory rate-setting approach (see Section 2.3.2). Additional information regarding the legal requirements and constraints impacting airline rate setting can be found in Chapter 5 of this Manual. It is important that both airport operators and airline parties be aware of these parameters when entering into a business negotiation.

If it is necessary for an airport operator to undertake the ordinance approach, it must adhere to rate-setting policy per the U.S. DOT's *Policy Regarding Airport Rates and Charges, June 19, 1996*, and it must set aeronautical fees and charges under a compensatory approach. The airlines may file a complaint to the U.S. DOT if the rate-setting approach does not adhere to this policy.

2.3 Types of Business Arrangements and Rate-Setting Methodologies

The two primary rate-setting approaches used in airport/airline business arrangements are the residual and compensatory approaches. A pure *residual* methodology is where the airlines bear the overall financial risk for the airport operation and, in turn, receive the benefit of all non-aeronautical revenue credited toward the calculation of their rates and charges. On the opposite side of the spectrum, a pure *compensatory* rate-making approach is where the airport operator assumes the overall financial risk for the airport operation. As such, the airport operator also does not provide any non-aeronautical revenue credits toward the airline rate base. There is also a third approach, generally called a *hybrid* methodology, that is any mixture or combination of the prior two approaches and may include a "revenue sharing" component of excess non-airline revenues generated at the airport.

It is important to note that when the term "risk" is used in this Manual, it is referring to "financial risk," and with situations that are in the normal course of business at an airport. For example, it is clear that under a residual approach, the financial "risk" is entirely airline risk. It is also generally clear that under a pure compensatory approach, the financial "risk" is borne by the airport operator. It is, however, also important to note that the airlines do still have some financial risk exposure under a compensatory arrangement if, for example, operating expenses increase. It is also recognized that, for those airports with outstanding revenue bond debt, with requirements

¹Policy Regarding Airport Rates and Charges, U.S. Department of Transportation, June 19, 1996.

in a bond resolution that must be addressed and satisfied, that when circumstances may warrant that an airport's ability to satisfy the rate covenant requirement of providing for a minimum of 1.25 times annual debt service, the airport operator will primarily seek to recover the shortfall necessary from the airlines. In that circumstance, the "risk" is then borne by the airlines, rather than the airport operator. For purposes of this Manual, any discussions of where financial risk resides is under the assumption of a normal day-to-day operating environment, and not under irregular or abnormal circumstances.

Federal law does not require any single approach to airline rate setting; however, it does require that the methodology used be applied consistently to similarly situated aeronautical users and conforms with the U.S. DOT's *Policy Regarding Airport Rates and Charges*. This policy also identifies five fundamental principles for airport operators to follow in setting airline rates and charges:

1. In general, the U.S. DOT prefers that airport operators and the airlines negotiate a rate-setting approach directly that is based on the local market within which they operate.
2. Airline rates, fees, and charges must be fair and reasonable.
3. Airline rates, fees, and charges may not unjustly discriminate against aeronautical users or user groups.
4. Airport operators must maintain a fee and rental structure that makes the airport as financially self-sustaining as possible.
5. In accordance with federal statutory provisions governing the use of airport revenue, airport operators may expend revenue generated by the airport only for statutorily allowable purposes.

Further details on each type of business arrangements/airline rate-setting methods are described below.

2.3.1 Residual

A pure residual rate-setting methodology is where the airlines assume the financial risk at the airport and the airport operator generally recovers the "net costs" of the airport operation from the airlines. Because an Agreement must be in place to employ a residual methodology, this means that the signatory airlines (or the airlines that are party to an Agreement) receive the benefit of all non-aeronautical revenues credited toward their rate base and only pay the airport operator fees and charges that are based on the remaining or the "net" cost of the airport operation. Additional general points about residual approaches are as follows:

- Airport operators have a strong assurance of revenues based on the financial guarantee by the airlines.
- Airport operators generally have less incentive for maximizing non-aeronautical revenue sources due to the airline's financial guarantee.
- Airport operators have less incentive for controlling operating expenses, as any increases are covered through airline rates and charges.
- As a tradeoff for the airline financial guarantee, airport operators generally have weaker balance sheets, reduced debt service coverage margins, and limited liquidity or discretionary cash balances.
- With limited available cash on hand, airport operators may generally have a higher cost of capital, because they may be required to bond finance a majority of its capital development.
- With all of the financial risk, the airlines are more exposed to financial and economic downturns in the aviation industry.

Since the airlines bear the financial risk, more airline capital development control often accompanies a residual Agreement. For example, the signatory airlines may be granted the right to review and approve airport capital development projects typically permitted through a

“majority-in-interest” (MII) provision. Some residual Agreements also provide for varying degrees of airline consultation on an airport’s operating expenses.

There are two primary types of residual rate-making approaches that are generally employed throughout the airport industry: an airport (or airport system if more than one airport is included) residual method and a cost center residual method. Under the *airport residual* method, the landing fee is generally calculated to cover all the remaining airport costs that are not recovered through all other airline and non-airline revenue sources. This methodology is also referred to as the “single cash register” method, in that the landing fee serves as the “balancing account” to provide assurance that the airport operator will not have a deficit. Table 1 presents a typical approach for airport system residual rate setting.

The *cost center residual* approach allocates all airport costs and revenues to the various airline cost centers that are used to derive airline rates (e.g., the airfield area, terminal building, apron area). These cost centers are then calculated to break even such that the net requirement of each is equal to the calculated airline revenue. For example, the airfield cost center will generally use signatory airline aircraft landed weight as the divisor, and the terminal cost center will generally use airline rented space within the terminal building as the appropriate rate divisor. Under the pure methodology, the signatory airlines receive all non-aeronautical revenue credits toward their rate base. Table 2 presents a typical approach for cost center residual rate setting.

Table 1. Typical airport residual rate-setting approach.

	Cost Centers			
	Terminal	Airfield	Other Areas	Total Airport
Operating Expenses	\$9,000,000	\$4,000,000	\$15,000,000	\$28,000,000
O&M Reserve Fund Requirement	100,000	80,000	180,000	360,000
Debt Service	4,000,000	4,000,000	7,000,000	15,000,000
Debt Service Coverage	1,000,000	1,000,000	1,750,000	3,750,000
Capital Charges	300,000	420,000	270,000	990,000
Other Fund Requirements	600,000	500,000	800,000	1,900,000
Total Requirement	\$15,000,000	\$10,000,000	\$25,000,000	\$50,000,000
Less: Non-Airline Revenue	\$9,000,000	\$1,000,000	\$22,800,000	\$32,800,000
Less: Other Airline Reimbursements	1,000,000	200,000		1,200,000
Net Requirement	\$5,000,000	\$8,800,000	\$2,200,000	\$16,000,000
Airline Leased Space (s. f.)	100,000			
Average Terminal Rental Rate (per s. f.)	\$50.00			
Total Terminal Rental Revenue	\$5,000,000		Less:	\$5,000,000
Net Airport Requirement				\$11,000,000
Total Airline Landed Weight (000-lbs)				4,400,000
Landing Fee Rate (per 1,000 lbs)				\$2.50
Airline Landing Fee Revenue				\$11,000,000

Source: Ricondo & Associates, Inc., September 2009.
Prepared by: Ricondo & Associates, Inc., September 2009.

Table 2. Typical cost center residual rate-setting approach.

	Cost Centers		
	Terminal	Airfield	Other Areas
Operating Expenses	\$9,000,000	\$4,000,000	\$15,000,000
O&M Reserve Fund Requirement	100,000	80,000	180,000
Debt Service	4,000,000	4,000,000	7,000,000
Debt Service Coverage	1,000,000	1,000,000	1,750,000
Capital Charges	300,000	420,000	270,000
Other Fund Requirements	600,000	500,000	800,000
Total Requirement	\$15,000,000	\$10,000,000	\$25,000,000
Less: Non-Airline Revenue	\$9,000,000	\$1,000,000	\$22,800,000
Less: Other Airline Reimbursements	1,000,000	200,000	
Plus: Allocation from Other Areas	1,100,000	1,100,000	
Net Requirement	\$6,100,000	\$9,900,000	\$2,200,000
Less: Allocation to Terminal			\$1,100,000
Less: Allocation to Airfield			1,100,000
			\$0
Airline Leased Space (s. f.)	100,000		
Average Terminal Rental Rate (per s. f.)	\$61.00		
Total Terminal Rental Revenue	\$6,100,000		
Total Airline Landed Weight (000-lbs)		4,400,000	
Landing Fee Rate (per 1,000 lbs)		\$2.25	
Airline Landing Fee Revenue		\$9,900,000	

Source: Ricondo & Associates, Inc., September 2009.

Prepared by: Ricondo & Associates, Inc., September 2009.

2.3.2 Compensatory

Compensatory rate making generally represents a “cost-based” approach, in that an airline pays for only the cost of facilities used or leased at a specific airport. This is different from the residual rate-making approach, where the airlines assume the risk and are responsible for guaranteeing that the airport operates on a financial break-even basis. Under the compensatory approach, the airport operator bears the “risk” of the financial performance of the airport; however, any potential financial “rewards” will also accrue to the airport operator if non-airline revenues sources are strong and perform well. Generally, compensatory Agreements or ordinances are found at mature airports that realize successful revenue generation and typically reflect positive cash flow. Some other key points regarding a compensatory approach are as follows:

- Airport operators have an incentive to maximize non-aeronautical revenue because they bear the financial risk, and, thus the financial rewards.
- Airport operators generally have higher levels of liquidity and discretionary cash on hand.
- Airport operators generally carry stronger operating and debt service coverage margins because there is less “margin for error” and they do not have the airline financial guarantee.
- Airport operators are more exposed to financial and economic downturns.

Because they do not bear the financial risk, the airlines generally have limited control over an airport operator's capital development under a pure compensatory business arrangement. The airlines may have some ability to review or vote on certain development occurring in the airline cost centers such as the terminal, airfield, and apron. Otherwise, capital development control may be eliminated entirely or pertinent provisions are very broad in definition, allowing the airport operator to undertake projects at its discretion without airline approval.

Under the compensatory approach, the airlines pay only for the cost of the facilities used or leased. Costs are calculated in the respective rate-making cost centers (e.g., airfield, apron, and terminal) based on direct assignment and include the allocation of indirect costs which support the direct day-to-day activities at the airport. This is generally done for operating expenses, operating expense reserve, debt service, debt service coverage, and amortization. The total cost requirement is then divided by the appropriate measurement in each respective cost center to arrive at the specific rate. For example, the airfield cost center will generally use total aircraft landed weight as the divisor, and the terminal cost center will generally use useable space (or sometimes rentable space) within the terminal building as the appropriate rate divisor. Under the pure methodology, the airlines do not receive any direct credit in their rate base for non-aeronautical sources of revenue.

For the purposes of calculating compensatory terminal rental rates, there are two basic types of compensatory rates (see Chapter 11 for further information on these rates):

1. **Compensatory Rental Rate**—uses useable space as a divisor, where useable space is generally defined as gross terminal space less electrical and mechanical space within the terminal. Under this methodology, the space divisor is larger and results in a lower average rental rate.
2. **Commercial Compensatory Rental Rate**—uses rentable or leasable space as a divisor, where rentable space is defined as airline space, plus concessions space, plus any other rentable space within the terminal building. Under this methodology, the space divisor is smaller and results in a higher average rental rate compared with the compensatory rental rate. While not the standard approach, there are circumstances where the divisor may be rented or leased, rather than rentable or leasable due to specific circumstances at a particular airport.

Table 3 presents a typical method for calculating rates and charges per a compensatory approach.

2.3.3 Hybrid

In most cases an Agreement may not reflect either a pure compensatory or pure residual business approach, because the risk/reward relationship negotiated is somewhere in the middle, as opposed to the absolute ends of the risk/reward spectrum. As such, it is very common to find a business arrangement or rate-setting approach that uses various elements from both. This methodology is called a "hybrid approach." For example, an airport rate-setting approach may incorporate a residual airfield area and a compensatory terminal into its overall business deal. Another example is where an airport operator and airlines agree that a form of compensatory rate-setting is appropriate for that airport; however, some form of non-airline revenue credit or sharing is preferred to keep airline rates and fees at levels considered reasonable. The options for a hybrid scenario are somewhat endless and generally match the level of risk each party is willing to bear at a particular airport; however, several "revenue-sharing" approaches (i.e., distribution of annual airport operator surplus net revenue) are presented as follows:

- **Amount of net revenue distributed** can be based on a determined percentage (e.g., 50 percent to airlines), a certain amount of revenue, or based on a certain non-airline revenue category(s).

Table 3. Typical compensatory rate-setting approach.

	Terminal Rate Calculations		Landing Fee Calculation
	Compensatory	Commercial Compensatory	
Operating Expenses	\$9,000,000	\$9,000,000	\$4,000,000
O&M Reserve Fund Requirement	100,000	100,000	80,000
Debt Service	4,000,000	4,000,000	4,000,000
Debt Service Coverage	1,000,000	1,000,000	1,000,000
Capital Charges	300,000	300,000	420,000
Other Fund Requirements	600,000	600,000	500,000
Total Cost Center Requirement	\$15,000,000	\$15,000,000	\$10,000,000
Total Useable Space (s. f.)	350,000		
Total Rentable Space (s. f.)		200,000	
Average Terminal Rental Rate (per s. f.)	\$42.86	\$75.00	
Airline Leased Space (s. f.)	100,000	100,000	
Total Terminal Rental Revenue	\$4,286,000	\$7,500,000	
Less: Airline Revenue Share Credit ¹		1,500,000	
Airline Terminal Rental Revenue		\$6,000,000	
Total Landed Weight (000-lbs)			4,800,000
Landing Fee Rate (per 1,000 lbs)			\$2.08
Airline Landed Weight (000-lbs)			4,400,000
Airline Landing Fee Revenue			\$9,152,000

¹ Certain airport operators that employ a commercial compensatory terminal rate-setting methodology may also have an airline revenue sharing credit.

Source: Ricondo & Associates, Inc., May 2009.
Prepared by: Ricondo & Associates, Inc., May 2009.

- **Application of net revenue** to the airlines can be based on several factors including, but not limited to, enplaned passengers (where only passenger carriers are applicable), amount of rates and charges paid, and direct credit against specified cost centers.
- **Treatment of revenue sharing credit** can also differ. For example, once it is calculated in the current fiscal year, it can be applied as a credit into the next fiscal year. Another example is that it can be estimated at the beginning of the fiscal year and then the actual amount can be applied in the current fiscal year upon the settlement of airline rates and charges.

It is important to note that the sharing of certain non-airline revenues generated in one cost center to subsidize another cost center can pose issues to the airlines regarding “fairness of costs.” For example, a credit to the airfield cost center of non-airline revenue generated in the terminal or ground transportation could be viewed as an “unfair” subsidy to cargo carriers. On the other-hand, crediting airfield non-airline revenues in the terminal could also be viewed as “unfair.” Section 4.3 contains additional information about cost center allocations of expenses and revenues.

Also, additional details and issues regarding terminal rate-setting methodologies are contained in Chapter 11.

2.3.4 Settlement

Because actual financial and aviation activity will differ from that budgeted or estimated, an Agreement generally includes a provision for a year-end financial settlement between the airport operator and signatory airlines. This can also be more commonly referred to as “true-up.” Essentially, a settlement consists of comparing the budgeted rates and charges calculations for a particular fiscal year with the final year-end *actual* rates and charges for that same fiscal year. A settlement provision is generally included in all Agreements no matter the type of rates and charges methodology used. However, it is not normally included without an Agreement.

It is also important to note that while the signatory airlines may receive some level of economic benefit for signing an Agreement and making a financial commitment to the airport operator (see Chapter 10), they are also the only group of airlines that will participate in a settlement. The airport operator has no legal recourse for settlement with those airlines that do not sign the Agreement. Therefore, the signatory airlines bear some financial risk if actual financial performance does not meet budgeted levels.

Near the start of each fiscal year, an airport operator prepares the airline rates and charges for that fiscal year based on budgeted information which generally includes enplaned passengers, aircraft landed weight, terminal space, operating expenses, debt service, non-airline revenue, and any other activity and financial information that is pertinent to the rates and charges formulas at a particular airport. Then throughout the year, airlines pay their respective rentals, fees and charges based on the budgeted rates. At some point, an Agreement could include a provision for a “mid-year” review of budgeted airline rates and charges to compare with actual (generally unaudited) results to date. To avoid large financial settlements and potential cash flow issues for both parties, there may also be other provisions in an Agreement that require a review and potential adjustment of airline rates and charges if actual results vary by a certain amount or percentage from budget.

After the end of the fiscal year, the airport operator will recalculate airline rates and charges per the formulas established in the Agreement based on actual results for that fiscal year. While this information can be unaudited or audited, the rates and charges formulas are generated with this actual information to determine what is required for settlement. If the airlines have paid more to the airport operator than was required, the airport operator reimburses the airlines for the difference. If the airlines have underpaid, then the airlines remit the difference to the airport operator.

There are several variations in Agreements regarding the mechanics of settlement provisions (e.g., actual checks written by either party; settlement amounts credited or charged to the subsequent fiscal year calculations). These provisions are generally determined during Agreement negotiations between airport operators and the airlines. However, the primary objective is that an Agreement will specify how the process takes place and that the appropriate amount of airline rates and charges to be paid by the signatory airlines and collected by the airport operator is based on actual financial performance for that fiscal year.

2.4 Recent Trends in Airport/Airline Business Arrangements

Prior to deregulation of the airline industry in 1978, Agreements were generally long term and were considered financial security for an airport operator’s revenue bond debt. As a result, the Agreements at many airports were for a term of 30 years, which made them coterminous with revenue bond debt. Many of these Agreements were also residual in nature, further providing for the financial security of the revenue bond debt.

However, with deregulation and the ease of entry for airlines into markets, the investment community gradually began to recognize that the true credit security for an airport's revenue bond debt was the underlying strength of an airport's market and its ability to continue to support growth in passenger traffic, rather than the Agreement in place at that particular airport. The following quote from Standard & Poor's Rating Service supports this point:

*While use agreements may provide an additional level of comfort if a particular airline ceases to operate or alters its routing structure, **the inherent demand in the air traffic market remains the ultimate security for the bondholder.** A strong market will continue to attract carriers to serve that demand, while even the strictest use agreement will not, in and of itself, ensure the timely payment of debt service.²*

As such, there has been a trend over the last several years toward airport operators moving further away from the residual side of the business arrangement spectrum. Generally, airport operators have been assuming more of the financial risk for their airport operation. Subsequently, airport operators have been assuming more control over their facilities as well. It is important that an airport operator fully understand its unique economic drivers and methodologies and its strengths and weaknesses before determining which methodology or combination of rate setting it wants to negotiate with the airlines (see Section 4.2). A sustainable level of risk needs to be built into any long-term business arrangement for both parties.

²Standard & Poor's Rating Service, Criteria: Governments: U.S. Public Finance Airport Revenue Bonds, June 13, 2007.

PART II

HOW DO WE GET STARTED?

Negotiation Process and Schedule

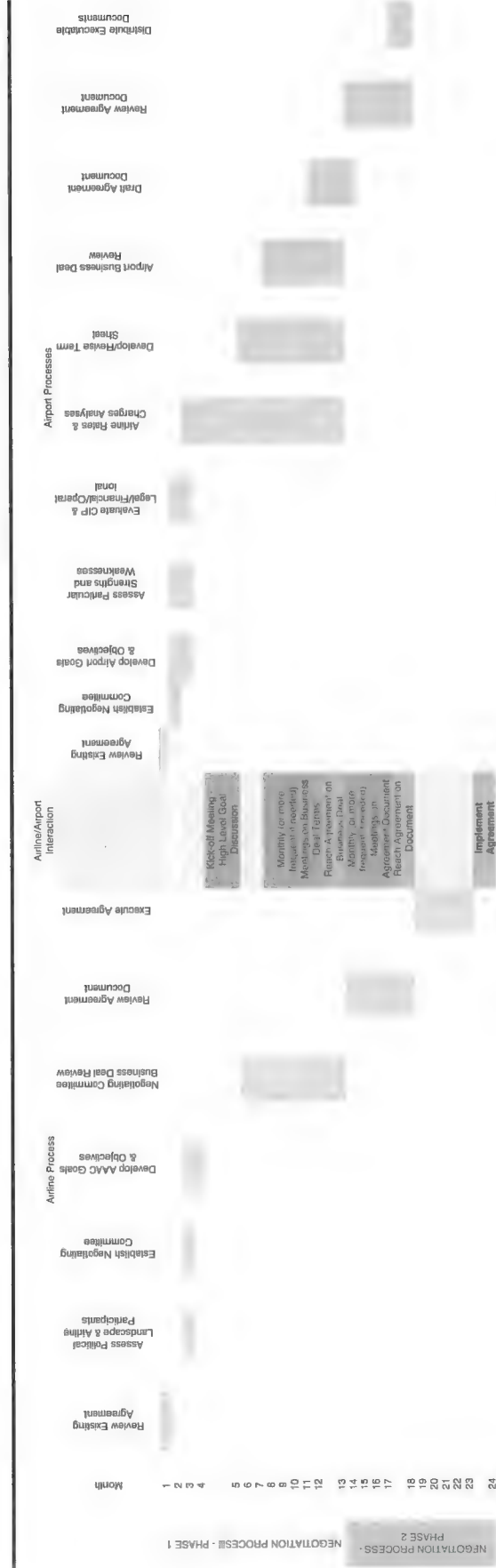
The general objective in negotiating Agreements is to develop a working relationship between the airport operator and the airlines as business partners, which ultimately will help each party achieve their respective goals and objectives. It is important to realize that compromise is part of this process for both parties; therefore, it is critical for each party to understand and prioritize its goals and objectives before entering into negotiations. A sample schedule of the negotiation process is presented on Exhibit 1. This schedule identifies typical steps, sequencing, meetings, and deliverables in connection with negotiations for the development of a new Agreement. The total time for this process can vary significantly from the timeline presented in Exhibit 1 depending on the complexity of issues involved in the negotiation and the amount of change sought in a new Agreement. In general, it is important to recognize that the negotiation process can take significant time and both parties need to begin preparations well before the current Agreement expires to minimize disruption in rate setting, airport cash flow, and the management and development of the airport.

As presented on the schedule in Exhibit 1, the negotiation process has been segregated into Phase 1 and Phase 2. Phase 1 of the process deals primarily with the negotiation of the business terms and provisions. Phase 2 is drafting the business deal into the actual Agreement document. This phase also includes the drafting of articles that will require legal review from both parties. Based on input received from airlines, airport operators, and general experience, splitting the negotiation into these phases has been found to be more productive because it focuses the negotiation upfront on the fundamental business elements of the Agreement. It will also enable a better understanding of what has been agreed on when writing the business deal into the Agreement document.

This chapter describes a typical negotiation process for both the airline and airport parties, identifies a sample timeline for negotiation activities, and presents some typical documentation that can be used to support a negotiation. The schedule contained in Exhibit 1 can be used as a guide to assist the reader through this chapter. Please note that the process outlined in this chapter is intended to be a general guide for informational purposes only. More often than not, there will be specific issues or factors that may impact the process and require additional steps (e.g., required airport board approvals, capital program reviews/approvals, legal reviews).

3.1 Typical Airline Negotiation Process

Once it has been determined that the business arrangement at an airport needs to be modified—either through the pending expiration of the current Agreement or certain circumstances that warrant a change—the airport operator and the airline-airport affairs committee (AAAC) will generally communicate their intentions to enter into negotiations. In most cases, one of the AAAC



Note: This schedule identifies typical steps, sequencing, meetings, and deliverables in connection with negotiations for the development of a new Agreement. The total time for this process can vary significantly from the timeline presented depending on the complexity of issues involved in the negotiation and the amount of change sought in a new Agreement.

Source: Ricondo & Associates, Inc., May 2009.
Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 1. Typical negotiating process schedule.

members will be designated by that committee to take the lead in organizing the negotiation effort on behalf of the airlines. This individual is generally designated as the “Airline Chairperson” and this selection can be determined based on several factors including, but not limited to, airport market share, overall experience, current workload, or general familiarity with the airport operator’s issues and staff.

Once the Airline Chairperson has been designated, the negotiation process for the airline side generally commences. A critical portion of the negotiation effort occurs before the initial meeting with the airport operator because the airlines need to develop their overall position. Details on the typical airline negotiation process follow.

Step 1: General Assessment

The Airline Chairperson is generally responsible for undertaking much of the groundwork leading up to the negotiations. The initial step in this process can include an assessment of both the airport issues and conditions and the various factors within the airline group that are anticipated to impact the negotiations. Depending on the familiarity and experience of the Airline Chairperson, this step in the process may be very brief because the issues may be very apparent, or may take some time because additional research may be required. A review of the existing Agreement should also be undertaken early in the process.

The Airline Chairperson will want to fully comprehend the various relevant political issues that may impact the upcoming negotiations. These issues may be on a local, regional, or even state level depending on the airport operator’s governance structure. Some examples of these issues can include the airline relationship with key airport operator decision makers, the influence of the local government on the airport operator, the airport operator’s governing body approval process, consultant involvement, and local or regional issues regarding noise and capacity to name a few.

After vetting the relevant airport factors, the Airline Chairperson will also assess the inter-airline issues that are anticipated to impact the upcoming negotiation. Understanding the general composition of the airlines serving the airport and their general viewpoints on various key negotiating issues will help the Airline Chairperson assess the relevant factors that will impact both the airport/airline negotiations and the inter-airline negotiations. The Airline Chairperson will need to develop an overall strategy to account for these issues for the negotiations. Certain examples of these include the following:

- Market share composition of airlines (i.e., are there any dominate airlines, and if so, are they low-cost carriers [LCCs], legacy, cargo?)
- Individual airline approval procedures for documents, and so forth
- Airline alliances and or affiliations within the group
- Individual personalities within the AAAC

In a number of instances, the airline parties may, through the AAAC, request the services of an Airline Liaison Office (ALO) to assist with selected activities at a particular airport. The AAAC at a particular airport is primarily responsible for determining whether an ALO should be created and financed, and for establishing the nature and extent of the ALO’s responsibilities. An ALO provides a variety of services, including technical, financial, and properties support at a specific airport on behalf of the participating parties at that airport. These ALOs may have a very narrow focus or a very broad focus, depending on the issues at the airport. In making a determination that an ALO is needed, the participating airlines must clearly define the proposed duties and responsibilities of the ALO. A key decision that must be made, in conjunction with the airport operator and appropriate legal counsel is whether the ALO will act in a consulting role, or whether the ALO will act as spokesperson for the participating airlines in the exercise of their duties.

Step 2: Establish a Negotiating Committee

Once the Airline Chairperson has assessed the various airport and airline factors that are expected to impact the upcoming negotiation, a determination will need to be made on airline representation for the negotiations. Given the effort and time required for a negotiation and the overall number of signatory airlines at certain airports—not to mention the various workload issues for members of the AAAC at a given time, it may be more practical to designate a subset of the AAAC as the negotiation committee. In some cases, a smaller group can also effect a more efficient negotiation. However, it is important to note that all airlines have a right to be involved in the negotiations.

If the AAAC agrees to create a negotiating committee, the following factors should be considered:

- The committee reflects a fair and reasonable composition of the airlines operating at the airport.
- Each member can commit to the required effort.
- Each committee member can maintain credibility in representing the overall position and his/her own position.

Step 3: Develop Airline Goals and Objectives

One major challenge for airlines in any negotiation is the conflict between determining goals and objectives for their individual businesses as opposed to those that are carried forward for the overall AAAC as part of the negotiations. To resolve this conflict, it is especially important for the Airline Chairperson and members of the negotiating committee (if applicable) to allow each airline to voice its goals and objectives. However, it is generally assumed that the negotiating committee will need to establish defined overall goals and objectives to enable a successful negotiation. Therefore, compromise and agreement amongst the AAAC in developing its goals and objectives are important steps in the process.

Goals and objectives can generally start as higher-level initiatives and then eventually materialize into more specific statements regarding what is to be accomplished. These goals and objectives can then be prioritized to reflect the overall negotiating objectives of the AAAC. If a separate negotiating committee has been established, the goals and objectives need to reflect those agreed upon by the broader AAAC.

At this point in the process, the airlines have generally completed their preparation for the negotiations. The airport operator normally undertakes its general preparation simultaneously (see Section 3.2 for more information on the airport process). Next, a kick-off meeting is scheduled to discuss each party's high-level goals, discuss the development of a term sheet, and establish a meeting schedule for the next several months. An example of topics included in term sheets used to assist in the negotiations is included in Exhibit 2. The number and frequency of negotiating meetings will depend on the overall complexity of the business objectives to be negotiated and how far apart the parties may be on them. It is suggested that meetings be scheduled at least on a monthly basis to keep the negotiations moving. It may be difficult to meet more frequently than monthly due to committee and airport operator availability, internal group review and feedback time, and other scheduling issues; however, in some cases, it may be required due to time constraints.

Step 4: Negotiating Committee Review of Business Deal

It is suggested that an agreed upon term sheet be used throughout the negotiations of the business deal to track what terms have been agreed upon and which warrant further discussion.

After each meeting with the airport operator, the negotiating committee should meet internally and communicate to the AAAC as needed on the status of the negotiations. The term sheet should be updated and discussed and any changes in strategy or negotiating positions should be resolved prior to the next meeting with the airport operator. It may take several meetings with the internal airline negotiating committee and with the airport to reach agreement on the business deal. Once agreement has been reached, the negotiations enter into Phase 2.

Financial	
Nonsignatory airline premiums	
Revenue sharing formula and methodology for distributing airline share	
Methodology for calculating landing fee, terminal rental rate and apron fee	
Joint use formula	
Majority-in-interest definition (e.g., airfield, terminal)	
Majority-in-interest threshold	
Pre-approved project list (exempt from MII)	
Rate of annual amortization of capital projects	
Terms of mid-year rate adjustments	
Extraordinary coverage protection	
Contract security	
Annual operating and capital budget consultation process	
Operational	
Space classification (i.e., what is exclusive use, preferential use, common use)	
Assignment and use of gates	
Assignment and use of other terminal facilities	
Other	
Term of agreement	
Signatory airline definition and minimum requirements	
Nonsignatory airline definition	
Affiliate definition	

Source: Ricondo & Associates, Inc., May 2009.
 Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 2. Items commonly included in a term sheet.

Step 5: Review Agreement Document

As with the business deal negotiations, the review of the Agreement document may take several iterations before both parties come to agreement. Therefore, a meeting schedule, both internally with the airline negotiating committee and with the airport operator, should be agreed upon in advance. The review of the Agreement document may also involve coordination with other departments within the airline (e.g., legal and finance); therefore, it is important to allow time for these groups to conduct their required due diligence.

Hint: In some instances, it may be more efficient from a time perspective to provide the airline legal departments with “non-business deal” articles of the Agreement during the business deal negotiations (i.e., articles dealing with damage and destruction, insurance, indemnification, general government provisions). These articles do not generally impact the fundamental business deal negotiations, and preparing them now could potentially save some required review time by airline legal groups at the end of the process.



At this point in the process, the airport operator is responsible for providing the first draft of the Agreement document and controlling and tracking changes after each meeting. It is important for the airlines to review the first draft of the Agreement to confirm that it properly reflects the business deal that was agreed upon during Phase 1 of the negotiations. The Airline Chairperson can be the point person for all airline comments to the airport operator on the draft Agreement. Time needs to be allotted for the airport operator to document the changes to the draft Agreement and to distribute the document to the airlines. Also, the individual airlines need time to review and provide comments to the Airline Chairperson in advance of the next meeting. This process takes place until agreement on the draft document is reached by both parties.

Step 6: Execute Agreement

Once the airlines and airport operator agree on the draft document, the airport operator distributes a final executable version of the Agreement to each airline expecting to sign. It is important to understand that each airline has to undergo its own internal approval before being able to sign an Agreement. Approval process time may vary. For example, one airline may be able to execute an Agreement within a week's time while other airlines may take several months for the approval process. This time needs to be understood by both airlines and airport operators and considered part of the overall time requirement anticipated for the completion of the negotiation process.

3.2 Typical Airport Operator Negotiation Process

Step 1: Review Existing Agreement and Develop Airport Operator Goals and Objectives

Parties on the airport operator side need to identify their specific financial and operational goals and objectives for the new Agreement. As a starting point, the airport operator parties should review their existing Agreement to identify and address any areas of concern, including the level of risk the airport operator parties are willing to assume. In general, the following types of information should be considered and evaluated (see Section 4.1 for further details):

- The airport's future capital development needs
- The level of control the airport operator seeks to maintain over its capital development program
- The level and type of control the airport operator needs over gates and other facilities
- The financial and operational commitment it is seeking from its tenant airlines
- How much discretionary cash flow is required to meet airport financial, operational, and developmental requirements

Once defined, the goals and objectives should be categorized into needs versus wants (**needs** are considered to be deal breakers from the airport operator's standpoint; **wants** are typically prioritized and assessed).

The airport operator may also want to consider the appropriate personnel for the negotiating committee. This may be the airport director, finance director, business development director, and other staff and or consultants required. This is the key group that will be involved throughout the process from the airport operator side.

Step 2: Assess Airport Strengths and Weaknesses

Each airport has fundamental economic and market characteristics that make it unique. The key to a successful negotiation from both the airport operator and the airline perspective is understanding these economic drivers and unique airport factors. Generally, handpicking certain business provisions or approaches from one airport may not necessarily work at another airport—so be cautious of this.

Some examples of key economic drivers and unique airport factors include the following. Please note that this is not an exhaustive list. There may be several more factors depending on the airport or market (see Section 4.2 for further details):

- Market orientation (e.g., origin, destination, major connecting hub)
- Overall passenger volumes and trends (e.g., hub size, rapid growth market)
- Air service composition (e.g., major low-cost carrier presence, cargo presence)
- General capital/debt position (i.e., has the airport just completed a major capital expansion or is it about to undertake one?)
- Local airport competition
- Overall levels of non-airline revenue (e.g., parking revenue, terminal concessions)
- Type of airport governance (e.g., state, city/county, authority)

Understanding these general factors will assist the airport operator with determining goals and objectives that may best capitalize on its strengths and mitigate its weaknesses. It may also provide the airport operator with a general understanding of its leverage position with the airlines.

Step 3: Incorporate Capital Development Needs and Develop Priorities

It is important to consider planned airport capital development needs for incorporation into the proposed business deal and airline rates and charges scenarios. The size and scope of future capital development needs can affect an airport operator's leverage in negotiating the new Agreement. All available capital funding sources should be examined in this step (i.e., Federal Aviation Administration [FAA] Airport Improvement Program grants, Passenger Facility Charges [PFCs], Customer Facility Charges [CFCs], available state sources) to assess the financial impacts on both the airport operator and the airlines.

Step 4: Prepare Rates and Charges Analyses and Business Proposal

This step can require significant effort because it is where the airport operator attempts to achieve its goals and objectives through quantified airline rates and charges. This process could include the development of alternative approaches to revenue enhancement, optimum treatment of debt service coverage, and a reexamination of funding sources for capital improvements (see Section 4.4 for additional information and suggested approaches to the development of airline rates and charges analyses).

Once the airport operator determines a preferred approach for its airline rates and charges methodology and has a general order of magnitude understanding of airline impacts, it is prepared for the kick-off meeting with the airlines as described in Section 3.1, Step 3. High-level goals, a schedule of meetings, and the development of a term sheet are generally discussed at this meeting.

The airline rates and charges analyses will most likely continue throughout negotiations with the airlines as the business deal evolves. The airlines may request certain analyses that measure financial impacts to the airlines as a whole and on an individual basis.

Step 5: Airport Operator Review of Business Deal

It is suggested that an agreed upon term sheet be used throughout the negotiations of the business deal to track what terms have been agreed upon and which warrant further discussion. Refer to Exhibit 2 for commonly included items on term sheets for airline/airport operator negotiations.

After each meeting with the airlines, the airport operator should meet internally as needed on the status of the negotiations. The term sheet should be updated and discussed and any changes in strategy or negotiating positions should be resolved before the next meeting with the airlines. It may take several meetings internally and with the airlines to reach agreement on the business deal. Once agreement has been reached, the negotiations enter Phase 2.

Step 6: Prepare and Review Draft Agreement

After the business deal has been agreed upon, the airport operator will be responsible for preparing a draft Agreement to incorporate the agreed upon business deal. An example table of contents for a typical agreement can be found in Appendix B.



Hint: It may be beneficial to start drafting a “boilerplate” Agreement during the business deal negotiations to save time in the schedule for document preparation. Also, in some instances, it may be more efficient from a time perspective to provide the airline legal departments with “non-business deal” articles of the Agreement during the business deal negotiations (i.e., articles dealing with damage and destruction, insurance, indemnification, general government provisions). These articles do not generally impact the fundamental business deal negotiations and preparing them now could potentially save some required review time by airline legal groups at the end of the process.

As with the business deal negotiations, the review of the Agreement document may take several iterations before both parties come to agreement. Therefore, a meeting schedule, both internally with the airline negotiating committee and with the airport operator, should be agreed upon in advance. The review of the Agreement document also may involve coordination with various airport departments (e.g., legal counsel); therefore, it is important to allow time for these groups to conduct their required due diligence.

Step 7: Distribute Executable Agreement

Once the airlines and airport operator agree on the draft document, the airport operator distributes a final executable version of the Agreement to each airline expecting to sign. It is important to understand that each airline has to undergo its own internal approval process before being able to sign an Agreement. Again, approval process time may vary. For example, one airline may be able to execute an Agreement within a week’s time while other airlines may take several months for the approval process. This time needs to be understood by both the airlines and the airport operators and considered part of the overall time requirement.

Key Items to Identify Prior to a Negotiation

Chapter 3 presented the overall process of negotiations; this chapter addresses the preparation, analyses, and development of preferred strategies to assist in the formulation of the business arrangement for the negotiations. This chapter will describe the importance of developing specific goals and objectives; the importance of proper accounting and categorization of airport finances; recognition of the constraints and parameters that a business arrangement must reside within; and development of the specific rates and charges formulas that quantify the business arrangement being considered and negotiated. Included in this chapter is the information to assist the airlines and airport operators in their analyses and evaluation of the business arrangement being negotiated.

4.1 Goals and Objectives

Before initiating any negotiations for a new Agreement, each party must understand and attempt to quantify what it is trying to achieve. This is accomplished through the development of goals and objectives and the prioritization of such. This section will describe this process from both the airline and airport perspective.

4.1.1 Specific Considerations for Airlines

Determining airline goals and objectives for a business arrangement negotiation can be a complex process because each individual company has its own internal process and goals that need to be incorporated and negotiated among the AAAC to arrive at consolidated objectives by the committee. Current economic conditions and unique market conditions of the airport where the negotiations are taking place also need to be considered. In other words, certain objectives one airline may have recently negotiated at another airport may or may not be those sought at that particular airport. Many factors influence the determination of airline negotiating goals and objectives at a particular airport such as airline market share, airport capacity constraints, and airport costs.

Each airline company has its own process for approaching an upcoming Agreement business negotiation, generally through its airport properties or corporate real estate departments. In determining its specific goals and objectives, an airline will determine how that specific airport fits into its overall corporate strategy. Some examples of what airlines do internally are as follows:

- Take an inventory of the amount and type of space the airline is currently leasing at the airport.
- Coordinate with other internal stakeholder departments such as aircraft scheduling, flight operations, maintenance, engineering, and cargo to assist in developing future space expectations at a particular airport.
- Determine the airline's level of control over its current space. For example, does the current situation provide for an ability to expand at the airport in the future?

- What is the age of the Agreement that is expiring or being changed? If the airport is coming off an old Agreement, there may be significant changes needed to update the situation.
- Analyze the costs to the airline. Are the costs prohibitive to the airline's future plans and how are the costs allocated among the airline users?
- Evaluate the airport's capital program. Depending on the size and scope, this can be a major driver of a future business deal. How does the capital program impact the airline and does it fit in with the airline's overall plans for that airport?
- The airline may also coordinate with its appropriate legal department early on to initiate an assessment of any specific areas of risk with regard to insurance, indemnification, and environmental provisions.
- Review historical trends in O&M expenses at the airport.

As discussed in Chapter 3, coordinating the efforts of the airlines (or AAAC) in Agreement negotiations is generally the responsibility of the Airline Chairperson. This person also takes on a significant role in developing the overall consensus goals and objectives of the AAAC for a negotiation. Some of the negotiating objectives for the airlines may be easier to arrive at a consensus, for example:

- Lowering airline rates and charges levels
- Ensuring costs are fairly and appropriately allocated among the users
- Flexibility in using or leasing needed terminal facilities
- Increasing control over certain capital development projects
- Minimizing airline financial risk for vacant terminal space

However, there are also several issues that may be more difficult to gain agreement on among all the airlines in the AAAC. Many of these types of issues can be related to specific applications of the objectives described in the preceding list, such as joint use formulas, treatment of affiliated airlines, thresholds for signatory status, and allocation of costs. Many of these issues are described in more detail in Part 3 of this Manual.

Airline Chairperson has the responsibility to solicit input from all the members of the AAAC and to look at the benefits and costs of the issues as a whole. Compromise is to be expected, and the airlines can generally work through the issues; however, in certain cases where consensus cannot be reached, the Airline Chairperson will generally notify the airport operator that agreement was not obtained. In these cases, it may require the airport operator to make a policy decision to assist in achieving resolution.

4.1.2 Specific Considerations for Airport Operators

One of the most important aspects of any negotiation of an Agreement is the determination of the airport operator's financial, operational, and developmental goals and objectives. After identifying the list of objectives, the airport operator should prioritize that list. An airport operator should focus on its particular objectives and the priorities of each, with due consideration given to its particular strengths and weaknesses, otherwise the following could occur:

- The airport operator may not know how well it did when the negotiations are completed, because it did not adequately quantify what it was trying to achieve before the negotiations began.
- The airport operator may find itself negotiating for provisions that are either conflicting or unnecessary, or worse, seeking a business arrangement that might be virtually impossible to obtain.

As part of this process, it is also extremely important that an airport operator not overly concern itself with provisions in Agreements at other airports. While it is recognized that using language from other airport Agreements that has been tested, tried, and revised for certain provisions may save an airport operator unnecessary time and frustration, a particular provision should never be used in an Agreement solely because it works for another airport operator. Each airport operator must negotiate for provisions that fit its particular circumstances.

For an airport operator, arriving at a list of negotiating objectives is an iterative process. The airport operator should first list its initial objectives, and then consider the issues and negotiating strengths it has to develop an acceptable strategy for the negotiation. For example, airport operator's objectives could include the following:

- A shorter term Agreement
- Reduction in the amount of exclusive space leased to the airlines
- Elimination of the current subleasing trend
- Greater flexibility and control over planned capital development decisions
- Ability to relocate airlines to better provide for new entrant or expanding airlines
- Increased discretionary funds for capital development
- Reasonable levels of airline fees and charges
- A more entrepreneurial business approach (especially if the existing Agreement is residual and the airport operator desires a more compensatory or hybrid approach)

Upon the initial development of its proposed business relationship with the airlines, it is important for an airport operator to focus on and develop its objectives for a negotiation, along with preparing the appropriate rates and charges documentation. In other words, the airport operator has to determine its absolute needs; what it wants beyond that; how reasonable the overall package is; and how much negotiating leverage it has. These elements are discussed in the following paragraphs.

Needs. This is the most critical area of an airport operator's objectives. Needs represent the bottom-line requirements of an airport operator's preferred business arrangement with the airlines and are relatively uncontrollable from the airport operator's perspective. The primary needs become the airport operator's most important objectives. These could be considered deal breakers for the airport operator. Two examples of critical needs could be (1) an airport operator planning to issue revenue bonds for its capital program must obtain a business arrangement that will provide reasonable security for the additional bonds and outstanding bonds in regards to the ability to meet its annual rate covenant and (2) if an airport operator plans to undertake a major capital program and airline support is sought for that, achieving a business arrangement that facilitates undertaking the capital program becomes an important "need."

There are many considerations that the airport operator will need to identify and evaluate as it develops its preferred business arrangement with the airlines. Some examples of these are as follows:

- Level of financial risk
- Reward and control tradeoffs
- Control over operating and development decisions
- Level of discretionary income
- Type of landlord-tenant relationship (preferential or exclusive, access clauses, subletting and assignment rights)

For an airport operator, determining its needs may appear straightforward but, typically, a lot of tough issues must be considered in this process. Most of these issues relate to sorting out a true requirement from a want that the airlines could view as unnecessary. The following are examples:

- An airport operator wants to develop additional space in the terminal should a new airline decide to serve that airport in the future. While the airport operator might consider this a critical need, any unreasonable amount of space should be considered a want.
- An airport operator may plan an ambitious and expensive capital program that the community feels is important. However, if the economics do not make sense for that particular airport, the potential enhancements may need to be moved to the want category.

Wants. Wants refer to all of the other provisions that an airport operator might seek in negotiating a new Agreement. There is nothing wrong with identifying as many wants as the airport operator believes is appropriate. However, these wants should be reasonable, and the airport operator should have sufficient leverage to obtain them. Wants are more discretionary objectives and relate to the airport's operating and developmental goals—the type of business arrangement the airport operator wants with the airlines. It is also important to note here that when identifying its objectives, an airport operator must take into consideration that an absolute necessity for it could be a discretionary objective at another airport, and vice versa. **Of primary importance is the ability to identify what an airport operator absolutely needs and what it would like to have. It must also be able to recognize the difference between the two.**

Also, there are reasonableness tests that need to be applied during the process of identifying objectives. For example, an airport operator might want the airlines to assume all financial risk in a new Agreement, while at the same time minimizing airline participation in capital and operating decisions. Airlines will not generally view this combination as reasonable.

4.2 Identifying Particular Negotiation Strengths and Weaknesses

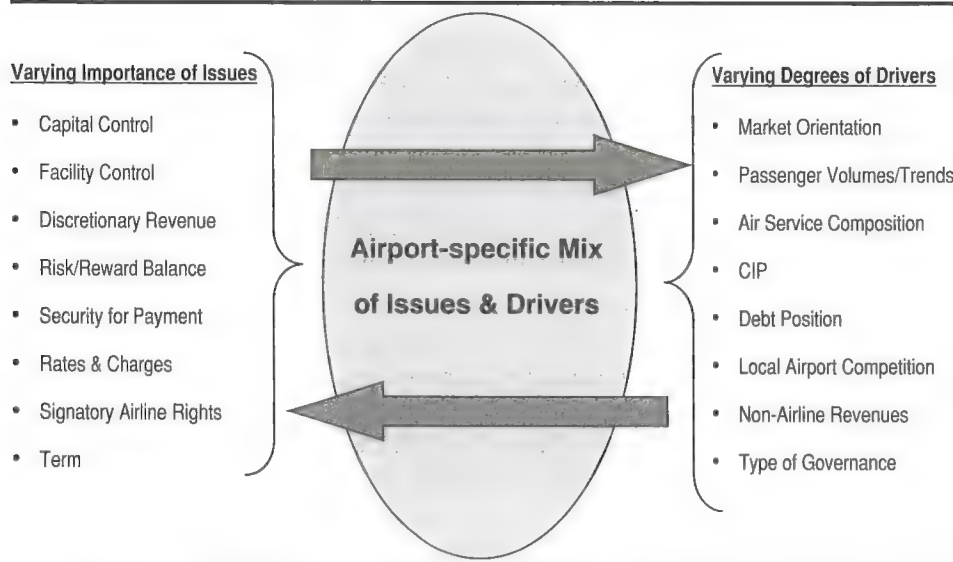
Before an airport operator can finalize its objectives or arrive at an overall negotiation strategy, it has to carefully examine all the factors that can impact the objectives identified, beginning with determining the airport operator's negotiating strengths and weaknesses (i.e., leverage). Essentially, leverage is the net total of an airport operator's negotiating strengths and weaknesses at any point in time. There are a number of internal (airport-centric) and external factors that help shape an airport operator's final objectives and negotiating package. These factors play a major role in identifying the amount of leverage an airport operator has during a negotiation.

Airport or internal factors include all the characteristics of an airport and its current situation that contribute to shaping what the airport operator is trying to accomplish and the degree of negotiating leverage that the airport operator has. The following are examples:

- What is the strength of the airport's underlying market?
- Does the airport have a strong origin and destination (O&D) base that will support multiple airlines?
- How robust is the airport operator's non-airline revenue?
- What is the airport operator's current debt position?
- Is there any other regional airport competition?
- Is the airport dominated by either a legacy airline or a low-cost carrier?
- Is the airport a connecting hub for a legacy airline or a focus city for a low-cost carrier?
- What are the current airport passenger volumes and how are they trending?
- Is the airport operator trying to undertake a major capital program at the same time it is negotiating a new Agreement?
- How does the airport operator's board or governing body respond to risk and reward tradeoffs?
- What is the importance to the airport of its operating versus developmental goals, and does the airport's board or governing body agree?

There are certainly many other particular circumstances that impact a particular airport operator. It is important for an airport operator to clearly recognize those factors that will impact negotiations, so that priorities and tradeoffs can be identified before initiating negotiations.

External factors potentially impacting an airport operator's objectives include the airline industry, financial community, and federal legislation, policies, and other legal factors. The state of the airline industry will certainly have an impact on an airport operator's negotiation. When an airport operator begins negotiating its Agreement with the airlines, will it be during a time of



Source: Ricondo & Associates, Inc., May 2009.
 Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 3. Airport operator goals and objectives versus strengths and weaknesses.

growth in the industry, or will the airlines be dealing with more pressing issues and be unable to focus on the particular airport's negotiation?

For the financial community, issues relate to the security of an airport operator's revenue bond debt. The business arrangement negotiated should consider the industry views of the investment community. Even if currently an airport operator does not have outstanding revenue bond debt, it may sometime during the term of the new Agreement. Generally speaking, the financial community is not focused necessarily on any particular type of business arrangement, but it must make sense for that particular airport, and provide adequate security for the revenue bond debt at that airport (Chapter 6 discusses investment community concerns in more detail).

No matter how reasonable an airport operator's objectives are, leverage is absolutely critical to the outcome of a negotiation. Leverage also shifts over time, and the airport operator must fully understand the amount of current leverage it has when entering a negotiation.

To summarize, anyone can write an Agreement that the other party will not sign. The airport operator must identify its initial wants and needs, then consider its negotiating strengths and weaknesses, then finally arrive at a "package" of objectives that represents a reasonable compromise between what it wants and needs and its ability to achieve such a package. Exhibit 3 presents this process in a graphical format. As illustrated, the varying importance of goals and objectives versus the differing degree of unique drivers for an airport, yield a specific mix that is unique to each airline and airport operator business negotiations.

4.3 Cost Centers and Allocations of Expenses and Revenues

As the development of rates and charges formulas are critical to the quantification of the business arrangement negotiated between the airport operator and airlines, it is also critical that the airport's accounting and cost center structure support that process. The airport's cost center account-

ing structure should maintain and categorize all of the airport's revenues, expenses (operating and non-operating), debt service, fund deposit requirements, and any other financial obligations into a formal group of cost centers for accounting and rate-making purposes. This structure also assists the airport operator in developing other tenant and user rates and charges, as well as understanding the areas of the airport that are financially self-supporting and those that are not, so the airport operator can focus on improving financial performance in those needed areas. Segregating key areas of the airport will also help ensure that costs that should be the obligation of one particular tenant or user are not being subsidized by some other tenant or user.

There are essentially two types of cost centers. One type is direct, revenue-producing cost centers in which the airport's physical and key functional areas will be organized into a group of revenue-producing cost centers that make up the airport boundaries. The other type is indirect or functional. These represent the various functions provided at the airport (e.g., operations, airfield maintenance, terminal maintenance, ARFF, and administration) that are either directly charged or assigned to specific revenue-producing cost centers or are allocated based on percentages.

4.3.1 Revenue-Producing Cost Centers

Typical revenue-producing cost centers could include the airfield, terminal, parking, cargo, hangars, and other key areas of the airport. If the airport operator is responsible for an airport system, the other airports in the system could become separate cost centers within the overall cost center structure. Depending on the size of the airport, or the size of any particular revenue-producing area, variations to the cost center structure are certainly acceptable. The airport operator should, however, strike a balance between developing enough cost centers to support its financial and accounting needs without developing so many cost centers that they create a cumbersome administrative burden.

Some airports may group all ground transportation functions (e.g., auto parking, rental cars, taxi, limousine) including all airport roadways, into a ground transportation cost center. If cargo or hangar are not material activities at an airport, a consolidated cost center could be developed for these aviation-related functions. Flight kitchens, general aviation, or other aviation-related activities could also be included in this "aviation" cost center.

The airfield cost center could include general aviation, fixed base operator facilities, and fueling facilities, depending on the airport operator's preference and the materiality of the activities in the airfield. However, some airport operators also include these particular activities in the aviation cost center and leave the airfield for the movement of aircraft through the taxiway and runway system at the airport. Another sub-area of the airfield consists of both the terminal aircraft aprons and the cargo aircraft aprons. It is preferred that these areas be isolated and segregated from the airfield, primarily for rate-making purposes, to ensure that the costs of operating, maintaining, and developing those particular facilities are borne by the specific tenants and users of those facilities.

There are also a number of "non-aviation-related" activities at an airport. These can include commercial buildings, hotels, various ground leases, and any other activities that are not directly related to aviation purposes. Here again, whether each non-aviation activity is a separate cost center or whether activities are grouped together into one cost center is primarily a function of materiality, airport operator preference, and the ability of the accounting or cost center system to segregate and isolate particular functions and activities.

Revenues of the airport, or airport system, should be "assigned" to their appropriate cost center for financial reporting purposes. Revenues are assigned and remain in that assigned cost center each year. Many revenue sources will be self-explanatory, but there are a few that would need to be assigned to multiple cost centers. For example, while rental car concession revenue would be in a ground transportation or separate rental car cost center, any counter or office areas leased

in the terminal would be assigned to the terminal cost center, and their support facilities may be assigned to a non-aviation cost center.

In summary, the identification and formalization of an airport's revenue-producing cost centers must provide for the transparent assignments and allocations of all accounting transactions in the airport's (or airport system's) revenues, expenses, debt service, fund deposit requirements, and any other financial obligations. There is certainly flexibility and freedom to identify selected cost centers at an airport, and to create separate cost centers depending on the level of activity at an airport, along with the need to isolate the financial performance of that activity. However, whatever structure is developed, the accounting must be transparent and consistently applied by the airport operator.

4.3.2 Functional Area Cost Centers

These functional areas or indirect cost centers are primarily for aggregating the costs of operation and maintenance expenses at an airport. Similar to airport revenues, functional cost centers can consist of a number of different functions that are represented in the expense stream. Typical functional areas could include operations, building maintenance, airfield maintenance, engineering, development, police, and ARFF. Other functions that typically fall under the category of "administrative" include executive, legal, marketing, public relations, finance, accounting, properties, administrative services, and human resources.

For many fees and charges developed from the rates and charges formulas which are cost-based rates and charges, it is very important that the process and formulas for assigning and/or allocating expenses to revenue-producing cost centers be transparent and reflect where these various functions are actually spending their time and effort. It is preferred that the airport operator's accounting system have the capability to directly assign expenses to cost centers, thereby minimizing those expenses that must be allocated based on percentages. While a job cost system, labor distribution system, and other software can contribute significantly to the accuracy of assignments and allocations, many airport operators are unable to absorb the financial burden to implement such systems.

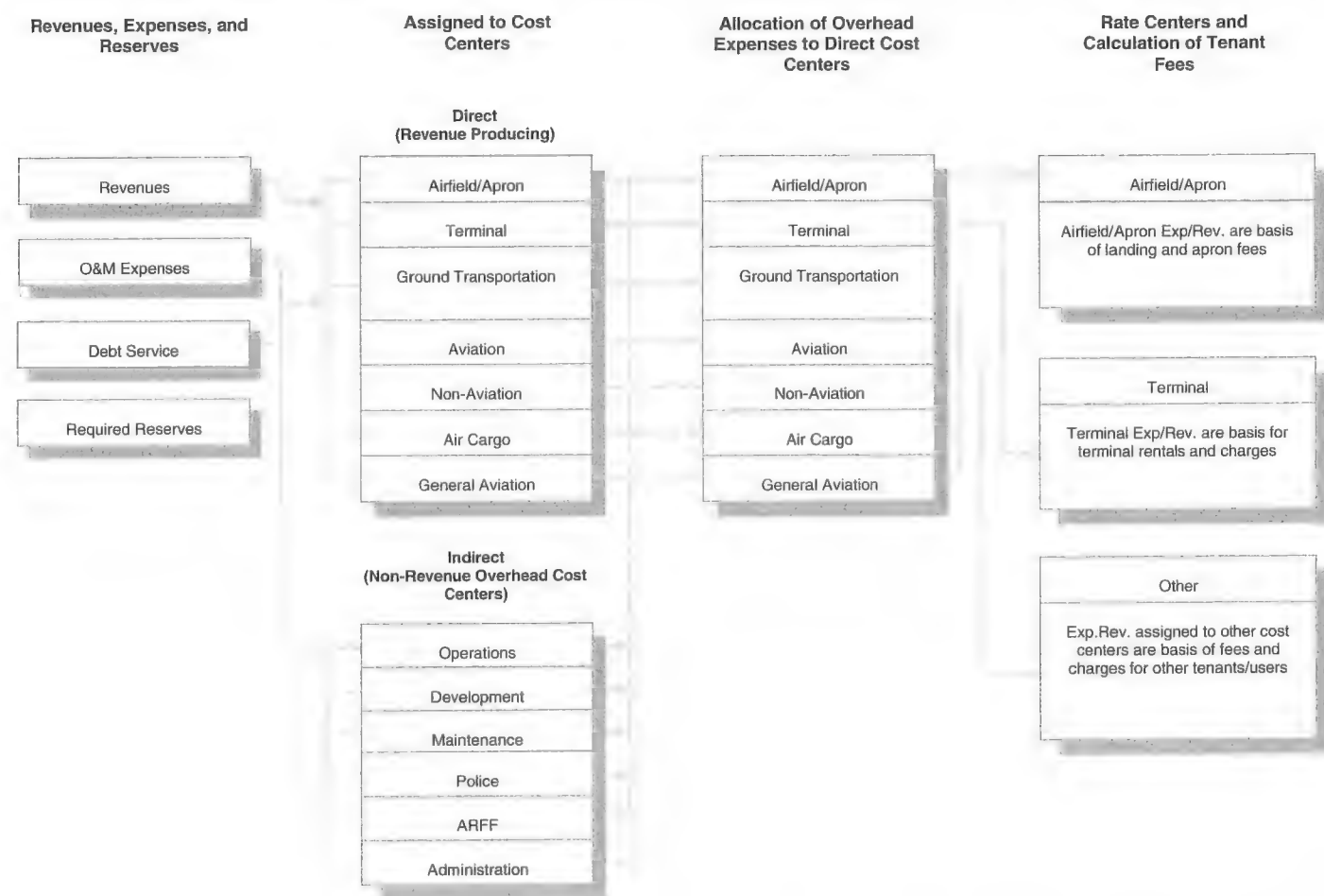
An alternative is for the airport operator to perform a review of its functions and determine the appropriate relationship to assign or allocate expenses throughout the revenue-producing cost centers. In some Agreements, some of these percentages may be "fixed" during the term of the Agreement. Other Agreements provide for the airport operator to monitor those relationships, evaluate them every 2 to 3 years, and adjust them as necessary when developing airline fees and charges. The goal is to minimize the subjectivity of the assignments and allocations through having a structured approach and process in place for both budget development and end-of-year settlement.

Exhibit 4 presents a typical cost center flow chart for illustrative purposes.

4.4 Capital Program Requirements

Identifying, planning, quantifying, and implementing a CIP represents another key aspect of a negotiation for an airport operator. In many cases, an airport operator is planning to undertake a CIP at the same time it is negotiating a new business arrangement with its airlines. In most cases, the financial impacts associated with the implementation of a CIP can represent the greatest increase in airline fees and charges at an airport. These impacts will receive the greatest scrutiny by the airlines in a negotiation. Therefore, it is critical that the airport operator plan and prioritize the CIP to balance the need for undertaking specific capital projects with minimizing the financial impacts to the airlines.

The CIP process can be a very long and drawn-out procedure with several challenges for an airport operator. The process is also one that needs to adapt to an ever-changing environment.



Source: Ricondo & Associates, Inc., May 2009.
 Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 4. Typical cost center flow chart.

In other words, the development of “permanent” facilities to accommodate dynamic aviation needs is a major challenge. One aspect in particular that can become an issue between airlines and airport operators in planning for facilities is the timeframe. Because airport operators generally take a broader perspective of supporting the overall aviation needs of the overall community and region, their planning horizon can be very long term in nature. A long-term planning process is also a requirement per the FAA’s airport master planning process. On the other hand, airlines may not necessarily share a similar long-term planning horizon at some airports because they need to be well positioned for flexibility to compete in a dynamic industry. Given these differing viewpoints, an airport’s CIP can become a major issue surrounding a business negotiation between airlines and airport operators.

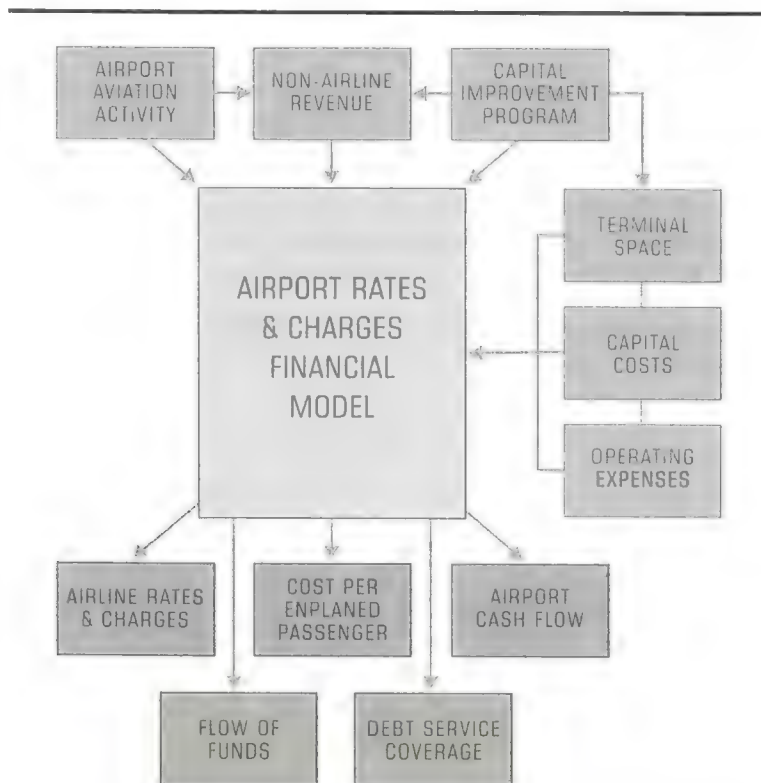
Airports are encouraged to make sure that any proposed capital development is consistent with the strategies for the airport, represents projects/programs that have been reviewed with key stakeholders (e.g., airlines), and is financially feasible. This becomes even more critical when an airport is negotiating an Agreement with its airlines at the same time as undertaking capital development. The airport operator needs to make sure that the capital development is worth potentially decreasing its leverage, thereby forcing it to accept a less than ideal business arrange-

ment with the airlines in exchange for being able to undertake the capital development. Appendix C provides greater detail about the capital development process and its management.

4.5 Airline Rates and Charges Analysis

Preparation of the rates and charges analysis will be one of the more important documents developed for a negotiation. This analysis quantifies the airport operator's primary goals and objectives through the proposed rates and charges formulas identified in the analysis. This document also incorporates all of the airport's financial and operational assumptions that are included in the analysis. It is important that the information presented in this analysis be presented in a clear and concise manner to assist the airline parties in understanding the rationale supporting the projections. It is also important that projections be realistic and supportable. Exhibit 5 presents the flow of information to be incorporated in the rates and charges analysis and is discussed in the following paragraphs.

Airport Aviation Activity contains the airport the projections of passenger enplanements and aircraft landed weight annually during the term proposed in the new Agreement. Knowing passenger enplanements will assist in the projections of those non-airline revenue sources that are driven, to a large degree, by passenger enplanement activity at the airport. It will also be used in calculating the joint use formula terminal revenues (by airline), and in measuring the projected cost per enplanement. The landed weight will be primarily used in calculating the landing



Source: Ricondo & Associates, Inc., May 2009.
Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 5. Typical flow chart for rates and charges financial model.

fee rate. **Terminal Space** identifies the breakdown of terminal space by functional area (e.g., ticket counter, holdroom, baggage claim, etc.) and category (e.g., rentable, public, administration, etc.). Depending on the proposed terminal rental rate formula, a category of terminal space will also be used in the calculation of the terminal rental rate proposed in the business deal.

The **Capital Improvement Program** and **Capital Costs** identify those projects expected to be undertaken during the term of the proposed agreement. The CIP will list all of the projects anticipated to be undertaken by the airport operator by cost center. It will also contain the assumptions of funding sources to be applied toward those projects. Capital Costs contains the annual impacts (e.g., debt service, amortization, PFCs applied to debt service) associated with the CIP that will be included in the business deal, whether directly in a rate base formula or in another airport cost center. The Capital Costs will also be included in the overall cash flow of the airport.

Operating Expenses and **Non-airline Revenue** will include projections for the proposed term of the Agreement. Where applicable, projections in these two areas should be developed for specific line items and distributed or allocated to the appropriate airport cost center. It is important to understand the distribution of responsibilities between the airport operator and the airlines when developing operating expense projections. A typical matrix that can be used as an exhibit to the Agreement describing operating expense responsibilities is illustrated in Exhibit 6.

Airline Rates and Charges are then calculated from the formulas established in the proposed business deal. This includes the specific rate structure for both the landing fee and the terminal rental rate, as well as other rates that may be calculated as part of the business deal (e.g., apron fee). From these rates, the total amount of airline costs will be calculated, and the resultant **Cost per Enplaned Passenger** will be calculated.

Airport Cash Flow includes the projections of all airline and non-airline revenues, as well as operating expenses, debt service, and any other obligations of the airport. In this same schedule, is the **Debt Service Coverage** ratio, which would be based on the calculation of the ratio as identified in the airport's bond resolution.

The final schedule is the **Flow of Funds** for the airport, again as defined in the airport's bond resolution. This would provide the beginning and ending balances for the airport's operating funds, as well as all activity in each respective fund for the year.

Appendix D contains a sample of the items that are generally included in a rates and charges negotiation document.

	Preferential Use Premises						Common Use Premises
	Ticket Counters	Offices & Operations	Bag Make-up	Aircraft Aprons	Hold-rooms	Jet Bridges	
Air Conditioning	C	C	n/a	n/a	C	n/a	C
Heating	C	C	C	n/a	C	n/a	C
Lighting							
a. Bulb & Tube Replacement ¹	A	A	A	C	C	A	C
b. Maintenance ¹	A	A	A	C	C	A	C
Electrical Maintenance ²	A	A	A	C	C	A	C
Water							
a. Distribution	n/a	C	C	C	n/a	n/a	n/a
b. Fixtures	n/a	A	A	n/a	n/a	n/a	n/a
Sewage							
a. Distribution	n/a	C	C	n/a	n/a	n/a	n/a
b. Fixtures	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Maintenance							
a. Other than Structure	A	A	A	n/a	C	A	C
b. Structure ³	C	C	C	C	C	C	C
c. Exterior ⁴	n/a	C	C	n/a	n/a	C	C
Custodial Service	A	A	A	n/a	C	A	C
Window Cleaning							
a. Exterior	n/a	n/a	A	n/a	C	n/a	C
b. Interior	n/a	A	A	n/a	C	n/a	n/a
Ramp - Concrete Repair	n/a	n/a	n/a	C	n/a	n/a	n/a
Snow Removal							
a. Larger ramp area ⁵	n/a	n/a	n/a	C	n/a	n/a	n/a
b. Gate areas & walkway to aircraft	n/a	n/a	n/a	A	n/a	n/a	n/a

A - AIRLINE

C - AIRPORT OPERATOR

¹AIRLINE shall be responsible for any light fixtures installed by AIRLINE.

²AIRLINE shall be responsible for any electrical fixtures or services installed by AIRLINE.

³AIRLINE shall be responsible for any structure constructed by AIRLINE.

⁴AIRLINE shall be responsible for any exterior maintenance required from actions of AIRLINE, its employees, or subcontractors.

⁵AIRLINE shall be responsible for coordinating removal of aircraft to allow for snow removal on airline ramp by AIRPORT OPERATOR; and, AIRLINE shall be responsible for snow removal around the Gate Areas/walkways/work areas, and shall be responsible for determining safety of passages for use by passengers/employees.

Source: Ricondo & Associates, Inc., May 2009.
Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 6. Operating expense responsibilities.

CHAPTER 5

Legal Constraints and Issues

The focus of this chapter is on the terms and conditions of Agreements. Over time, many airports and airlines have found it desirable to enter into Agreements that contain mutual commitments and specify key aspects of their relationships (such as the rules governing airport rate setting and the use of airport facilities). It is important to recognize, however, that Agreements are not required by law. In the absence of an Agreement, airports can establish by ordinance, resolution, tariff, regulation, or other unilateral action the local rules that will govern the airlines' use of their airport facilities. At many airports, rates and charges, rules controlling the use of terminal space, and other important terms and conditions for the use of the airport have been established in this way.³ In the absence of an Agreement, however, airlines serving an airport retain their right to challenge the legality of the terms and conditions imposed by the airport sponsor. The following are examples of airports that currently operate without Agreements:

- Gerald R. Ford International Airport (Grand Rapids)
- Phoenix Sky Harbor International Airport
- Sacramento International Airport

In considering whether to enter into a new Agreement (or extend an existing one), both airports and airlines should understand what the governing rules would be if there were no agreement. We refer to these as the "default" rules and focus on applicable federal aviation law.⁴

Federal aviation law takes several main forms: (a) statutes enacted by Congress; (b) regulations or policies promulgated by the U.S. DOT or FAA; (c) adjudicatory decisions by the U.S. DOT or FAA; (d) judicial decisions considering federal statutes or actions by the U.S. DOT and FAA and, sometimes, applying constitutional principles; and (e) non-binding guidance from the U.S. DOT or FAA. In the absence of an Agreement, federal aviation law provides a number of important default rules that affect federally obligated airports through statutorily mandated FAA Airport Improvement Program (AIP) grant assurances and otherwise.⁵ These regulatory rules have been the subject of important U.S. DOT rulemaking and adjudicatory action and judicial decisions especially as they relate to airport rates and changes.

³There can also be a mix of approaches at an airport. Agreements governing the use of passenger terminals, for example, can be coupled with the establishment of rates and charges by tariff. Agreements with "signatory" carriers are often paired with ordinances or regulations that govern the terms and conditions applicable to "non-signatory" carriers.

⁴There is enormous variation in the state and local laws potentially affecting the affairs of airport sponsors. They are outside the scope of this study.

⁵All the commercial service airports in the United States participate in the federal AIP and are bound by AIP grant assurances. The standard forms of these assurances can be found on the FAA's website: http://www.faa.gov/airports_airtraffic/airports/aip/grant_assurances/media/airport_sponsor_assurances.pdf.

We focus on the default rules of four key issues: (1) rates and charges, (2) facility control, (3) capital programs, and (4) legal “boilerplate.”

5.1 Rates and Charges

Where no Agreement is in effect, an airport can impose fees for airline use of airport facilities—such as landing fees and terminal rents—but the airport’s rates and charges fees must be “reasonable” and not “unjustly discriminatory.” 49 U.S.C. § 47107(a)(1); Grant Assurance 22. These standards have their roots in constitutional law, but have in recent years been the subject of significant statutory and regulatory action. A quick review of this legal history may provide useful insight into how these rules have developed and could affect future airport-airline negotiations.

In 1973, the Supreme Court considered whether an airport operator could levy a “head tax” of one dollar/passenger to help defray its capital and operating costs. The Court held that the Commerce Clause of the United States Constitution requires that rates imposed by an airport operator reflect a “fair approximation” of use of facilities, not be “excessive in relation to the benefits conferred,” and not discriminate against interstate commerce. *Evansville-Vanderburgh Airport Auth. Dist. v. Delta Airlines, Inc.*, 405 U.S. 707, 716-717 (1972) (*Evansville*). The Court found that the head tax at issue satisfied these constitutional requirements.

Following the *Evansville* decision, the airlines sought relief from Congress. Congress swiftly enacted the “Anti-Head Tax Act” (AHTA) in 1973. The AHTA prohibits “. . . a tax, fee, head charge or other charge on an individual traveling in air commerce . . .,” but permits an airport operator to charge “reasonable” landing fees, terminal rents, and other fees for the use of the airport.⁶ Congress did not, however, define what it means to be “reasonable.”

In 1982, Congress enacted the Airport and Airways Improvement Act of 1982 (AAIA), which provides for federal funding under the AIP and prescribes the statutorily mandated grant assurances. Each airport sponsor must provide assurances to the FAA that the airport will be available for public use on “reasonable” conditions and without “unjust discrimination.” 49 U.S.C. § 47107(a)(1); Grant Assurance 22. Once again, Congress offered no definition of what it means to be “reasonable” and offered no specific guidance about what rate-setting methods an airport could use if it had no Agreement. Congress did, however, provide with respect to “unjust discrimination” that air carriers making “similar use” of an airport must be subject to “substantially comparable charges,” except for differences “based on reasonable classifications” such as tenants/non-tenants or signatory/non-signatory carriers. 49 U.S.C. § 47107(a)(2); Grant Assurance 22. Congress also provided that airport rates should “make the airport as self-sustaining as possible” under local circumstances. 49 U.S.C. § 47107(a)(13); Grant Assurance 24.⁷

Several years later, various major commercial airlines sought a judicial determination that it is inherently unreasonable for an airport sponsor to impose “compensatory” rates and charges without an Agreement, even if the challenged rates only recover the airlines’ fairly allocated share of the actual costs of the airport facilities they use. The airlines claimed

⁶49 U.S.C. § 40116(b), (e) (“Anti-Head Tax Act”). Congress amended the Anti-Head Tax Act when it enacted 49 U.S.C. § 40117 (the “PFC Act”), which permits the collection and use of passenger facility charges (“PFCs”) at airports to fund certain capital projects.

⁷Congress has specified that an airport cannot include within its charges any costs covered by federal AIP grants or by PFCs. See 49 U.S.C. §§ 40117(g) & 47107(a)(13). The rate payable by an airline for exclusive or preferential use of a PFC-financed passenger terminal can be no lower than the rate payable by air carriers for the use of a similar facility at the airport that was not PFC-financed. 49 U.S.C. § 40117(g)(3).

that even in the absence of an Agreement, they had a legal right to share in the airport's non-aeronautical (concession) revenues. The airlines brought suit against Kent County, Michigan, the sponsor of the Gerald R. Ford International Airport in Grand Rapids. Kent County established its rates on a compensatory cost-recovery basis. After years of litigation, in 1994 the Supreme Court ruled that compensatory rate-setting is not inherently unreasonable; upheld the challenged fees in Grand Rapids because they were calculated on a "break-even" cost-recovery basis; and observed that the U.S. DOT and FAA (rather than the courts) should adjudicate issues of this kind. *Northwest Airlines, Inc. v. County of Kent, Michigan*, 510 U.S. 355 (1994) (*Kent County*).

As they had in the aftermath of *Evansville*, the airlines immediately sought relief from Congress, asking for legislation that would bar the imposition of compensatory rates in the absence of an Agreement. In the FAA Authorization Act of 1994 (FAA Authorization Act), Congress reaffirmed that airport fees may be calculated pursuant to either a compensatory or residual rate-setting method or a combination of the two methods, but again mandated that they be "reasonable." 49 U.S.C. § 47129(a). Congress provided for expedited review by the U.S. DOT of any airport-airline rate disputes.⁸ Rather than offering any definition of its own, Congress instructed the U.S. DOT to issue guidelines establishing the standards to be used for determining whether an airport fee is reasonable. 49 U.S.C. § 47129(b)(2). In June 1996, the U.S. DOT issued its *Final Policy Regarding Airport Rates and Charges* (1996 Rates and Charges Policy). 61 Fed. Reg. 31994 (Jun. 21, 1996).

The 1996 Rates and Charges Policy contains an elaborate set of rules governing airport rate-setting. Although its details are too numerous to summarize here, several key principles are as follows:

- The policy does not govern rates that are set by Agreement with the airlines.
- Compensatory rates can be established without airline agreement.
- Residual rates cannot be established without an Agreement.
- When setting rates without an Agreement, an airport sponsor should consult with the affected airlines before establishing new fees and should provide enough information to the airlines to permit them to evaluate the reasonableness of the proposed new rates.
- The composition of rate bases and the methods of cost allocation used to establish compensatory rates must comply with detailed U.S. DOT rules when they are set without an Agreement.

The 1996 Rates and Charges Policy differentiates between rates for the use of the *airfield* (which could only recover historic costs) and rates for the use of *non-airfield* assets (which could be based on "any reasonable method"). In 1997, however, the Court of Appeals for the District of Columbia vacated various provisions of the 1996 Rates and Charges Policy, finding that the U.S. DOT had not adequately justified its distinction between airfield and non-airfield rate setting. *Air Transport Ass'n of America v. DOT*, 119 F.3d 38, 129 F.3d 625 (D.C. Cir. 1997). The U.S. DOT began, but then abandoned, curative rulemaking proceedings in response to the Court's order and has never replaced the provisions vacated by the Court in 1997.

There are many unresolved issues under the 1996 Rates and Charges Policy. Two persistent disputes involve (1) whether the rules governing airfield rate-setting (which bar the use of fair market value) must also apply to terminal rate setting and (2) what kinds of rate differentials between signatory rates (under agreements with airlines) and non-signatory rates (imposed without airline agreement) are permissible and not unjustly discriminatory.

⁸Airlines must file a complaint within 60 days after receiving written notice of a new or increased fee, and the DOT must complete its adjudication of such a complaint within 180 days after it is filed. 49 U.S.C. §§ 47129(a)&(b). As required by Congress, 49 U.S.C. § 47129(b)(1), DOT has promulgated detailed procedural rules governing these expedited rate adjudications. See 14 CFR Pt. 302. The details of these procedures are beyond the scope of this report.

A third controversial issue is whether airport sponsors can impose rates that are designed to bring the demand for the use of congested airport facilities into alignment with their capacity without an Agreement. In 2008, the U.S. DOT amended the 1996 Rates and Charges Policy to make explicit the ability of sponsors of “congested airports” to establish rate structures, including “two-part” landing fees, that are designed to provide economic incentives to air carriers to reduce their operations during “peak hours,” increase (or “upgauge”) the size of their aircraft, or use alternative regional airports even if the affected air carriers object. (See Policy Regarding Airport Rates and Charges, 73 Fed. Reg. 40430 [Jul. 14, 2008]). The trade association representing the majority of the largest U.S. commercial airlines has challenged the U.S. DOT’s 2008 amendments, claiming (among other things) that the use of congestion pricing is barred by the 1978 Airline Deregulation Act, 49 U.S.C. § 41713(b), which precludes state or local government from enforcing local laws related to air carrier “prices, routes or services,” but preserves airport proprietors’ rights. *Air Transport Ass’n of America v. DOT*, No. 08-1293 (D.C. Cir.)(pending). Both the U.S. DOT and the major airport trade association, ACI-NA, are claiming that airport sponsors have a proprietary right to use congestion pricing when it is otherwise reasonable and not unjustly discriminatory. A decision by the Court of Appeals was not available at the time this Manual was written.

Over the past 15 years, there have only been a few complaints brought to the U.S. DOT challenging airport rates and charges that were set without an Agreement. In many of these cases, there have been subsequent appeals to the U.S. Court of Appeals for the District of Columbia Circuit. These agency and court decisions provide additional guidance on the proper interpretation and application of particular provisions of the U.S. DOT’s 1996 Rates and Charges Policy and associated federal statutes.⁹ They should be consulted, along with the policy itself, when considering what rate-setting methods an airport could use in the absence of an Agreement. The issues considered by the U.S. DOT and the Court of Appeals in these proceedings have included the following:

- Whether a landing fee can be based on the fair market value of airfield land;
- Whether imputed interest can be charged for projects financed with airport equity;
- Whether debt service coverage can be recovered through a landing fee;
- What rules govern the allocation of airport roadway costs to airline rate bases;
- When the costs of municipal police and fire departments can be reflected in rates;
- Whether the costs of public space can be allocated to airline terminal rates if there is no provision for revenue sharing (commercial compensatory rates);
- Whether equalized terminal rents can be imposed; and
- What kinds of signatory and non-signatory rate differentials are permissible.

In evaluating rate-setting provisions that have been offered in a proposed Agreement, both sides (airports and airlines) should take into account what kinds of rate-setting methods the airport could use under applicable default rules if they fail to reach an agreement. The U.S. DOT’s 1996 Rates and Charges Policy and the decisions by the U.S. DOT and the Court in adjudicatory rate-setting proceedings governed by the Policy provide detailed guidance on many issues that are likely to come up during negotiations. The underlying statutory standards (“reasonable” and not “unjustly

⁹See, e.g., *Los Angeles Int’l Airports Rates Proceeding*, DOT Docket OST-97-2329, and *Second Los Angeles Int’l Airports Rates Proceeding*, DOT Docket OST-95-474, and two related appeals, *City of Los Angeles v. DOT*, 103 F.3d 1027 (D.C. Cir. 1997), and *City of Los Angeles v. DOT*, 165 F.3d 972 (D.C. Cir. 1999) (landing fees at LAX); *Miami Int’l Airport Rates and Charges Proceeding*, DOT Docket OST-96-1965, and *Air Canada v. DOT*, 148 F.3d 1142 (D.C. Cir. 1998) (equalized terminal rents at MIA); *Brendan Airways, LLC v. The Port Auth. of New York and New Jersey*, DOT Docket OST-05-20407, and *Port Auth. of New York and New Jersey v. DOT*, 479 F.3d 21 (D.C. Cir. 2007) (terminal rents at EWR); *Alaska Airlines, Inc. v. Los Angeles World Airports*, DOT Docket OST-2007-27331, appeal pending, *Alaska Airlines, Inc. v. DOT*, Case No. 07-1209 (D.C. Cir.) (terminal rents at LAX).

discriminatory”) are, however, inherently elastic, and the precise limits on the rate-setting powers of airport sponsors will in many respects remain subject to case-by-case adjudication.

5.2 Facility Control

Agreements typically provide detailed provisions granting signatory carriers exclusive, preferential, joint or common use rights to use designated airport premises in exchange for various commitments by the airlines. In the absence of an Agreement, airports must provide access to their facilities on reasonable and not unjustly discriminatory terms. 49 U.S.C. § 47107(a)(1); Grant Assurance 22. If there is no Agreement, airlines have no legal right to exclusive or preferential use of airport premises, but airports will not be advantaged by whatever compensating commitments the airlines might make to gain exclusive or preferential rights.

5.3 Control of Capital Program

Agreements can give airlines some influence over or input into airport capital program decision-making (through MII provisions). When airlines agree to provide a financial backstop for the airport operator’s debt, their Agreement may be coupled with a promise by the airport operator to share its non-airline revenue. In the absence of an Agreement, however, airports retain control of their capital programs and their non-airline revenue, but bear the attendant financial risk. Airports have no right to impose residual rates and airlines have no right to revenue sharing without an Agreement (U.S. DOT 1996 Rates and Charges Policy, ¶ 2.1.1). For further details on business arrangement types see Chapter 2.

5.4 Boilerplate

Agreements often contain elaborate contractual provisions containing legal boilerplate specifying such things as payment rules, insurance requirements, environmental conditions, and indemnity obligations. In the absence of Agreements, some airports have imposed ordinance, resolution, tariff, or regulation comparable requirements as a condition of operating at the airport. The ability of airports to impose such conditions, and their effectiveness in the event of a dispute, has not yet been fully resolved.

Investment Community Concerns and Issues

The Agreement or the rate ordinance is a fundamental element of the business arrangement between an airport operator and its tenants. As such, it governs the way airports generate revenue and implement their CIPs. How this arrangement functions is an important factor for investors and credit rating agencies as they make their decisions about an investment in or the rating assigned to a particular airport's bonds. This chapter is designed to provide airport operators and their airline tenants insight as to how the investment community views the Agreement, and how decisions on how to craft their Agreement influence the rating and investment process.

This section considers the five main areas that impact how the investment community views the Agreement:

- U.S. bond market conditions
- Rate-setting mechanism chosen
- Term of the Agreement
- Gate usage provisions
- Capital spending provisions

6.1 Airports and the U.S. Municipal Bond Market

By their nature, airports are capital intensive enterprises. The need for significant up-front investment in major facilities such as terminals, runways, taxiway networks, and road systems requires that airport operators have access to external capital resources to finance such infrastructure. As airports in the United States are generally owned and operated by public entities, an important source of external capital is the municipal bond market.

The U.S. municipal bond market is a rather unique entity in the global capital markets. It is a well-established and deep market providing capital resources to a broad array of state and local governmental entities. The Federal Reserve estimates that municipal issuers had \$2.2 trillion of debt outstanding at the end of the third quarter of 2008.¹⁰ Buyers in the marketplace include individuals, insurance companies, banks, mutual funds, and other entities that seek the safety of the generally high credit quality of municipal issuers, as well as the advantage afforded by the federal tax-exemption for interest payments on most debt issued by state and local governments.

The high credit quality of municipal issuers is borne out by the lack of defaults in the market. All three major bond rating agencies, Fitch Ratings (Fitch), Moody's Investor Service (Moody's), and Standard and Poor's Rating Services (S&P) have undertaken municipal bond default studies that

¹⁰Flow of Funds Accounts of the United States, Flows and Outstandings Third Quarter 2008, December 11, 2008, Board of Governors of the Federal Reserve System.

have found that municipal default rates are well below those for corporate bonds. In fact Fitch's 2003 default study found that the cumulative default rate for municipal bonds issued between 1979 and 1997 equaled 0.84 percent. This study covered all municipal debt defaults from January 1, 1980, through October 2002, not just debt rated by Fitch. Transportation related issuers had an even lower default rate of 0.04 percent for the same period, with the study indicating no evidence of a default on a general airport revenue bond (GARB) by a major commercial airport. However, defaults have occurred related to special facility debt repaid by the sponsoring airline.¹¹ Moody's and S&P indicate similar results in their respective default studies, which focused only on transactions rated by the respective firms.^{12,13}

The strong repayment history of the nation's major commercial airports stems from the central role they play in the nation's economy and limited competition between individual facilities, as well as the cost recovery nature of their operations and federal grant requirements that restrict the use of airport resources solely for airport purposes. As Fitch notes in its criteria, "... the cost recovery aspect of most airport/airline operating leases allows airport operators significant flexibility to transfer operating and debt service costs to the tenant airlines, effectively softening the impacts of economic cycles."¹⁴ These factors are reflected in the consistently high bond ratings assigned to GARB debt. The combination of high credit quality and tax-exempt income results in airport operators having access to a deep pool of capital with borrowing costs typically favorable to those available in the corporate bond market. While solidly in the investment grade spectrum,¹⁵ the fact that airport ratings mostly range from the "AA" to "BBB" rating categories indicates there is a modest level of perceived economic and operational risk associated with airport-backed debt. Exhibit 7 shows the current distribution of senior lien airport bond ratings.

Investors in municipal bonds are typically interested in full and timely payment on their bonds and the resultant income stream, rather than total return favored in other markets. Thus, they are generally risk-averse, accepting lower interest rates in return for the consistency and timeliness of the payment stream. The bond ratings assigned to municipal debt are generally designed to measure the risk associated with the ability and willingness of the issuing entity to make its debt service payments in full and on time.

In assessing the risk associated with an investment in a GARB transaction, investors and rating agencies look at a variety of factors including (but not limited to) the underlying economic fundamentals of the enterprise, the level of service provided by the airlines, the strength of the airport's air trade area, the relative market positions of the airlines, the amount of debt issued or expected to be issued by the airport operator, and the financial operations and performance of the entity. They also review two key documents, the bond indenture (or ordinance) and the Agreement (or rate ordinance and permit).

The bond indenture outlines the obligations the issuing entity has to its bondholders. General provisions include the pledge of security that will be used to repay the debt, the flow of funds,

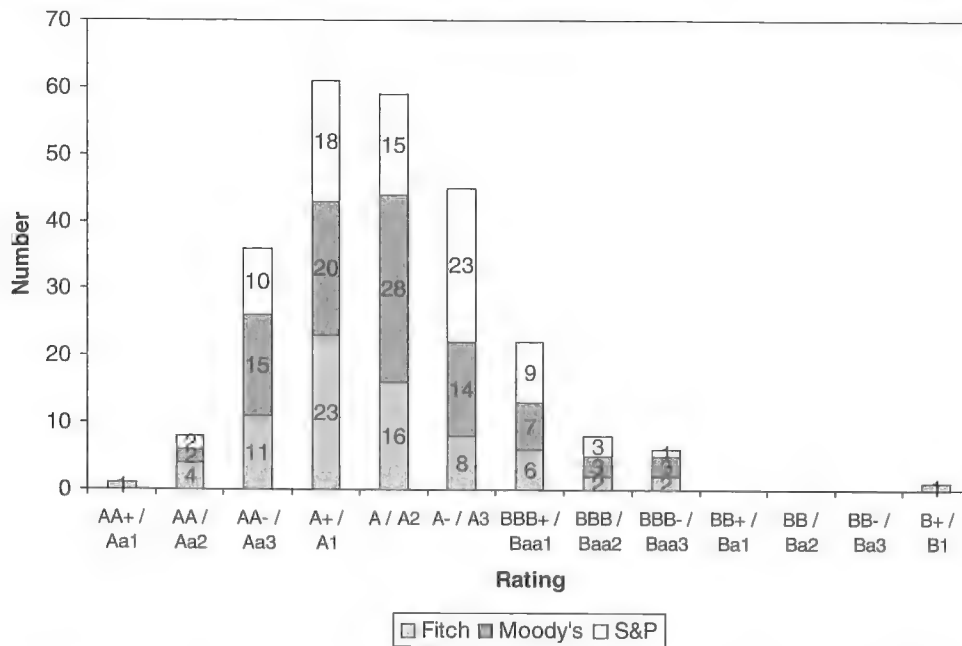
¹¹Fitch Ratings, *Municipal Default Risk Revisited*, June 23, 2003.

¹²Moody's Investor Service, *Moody's U.S. Municipal Bond Rating Scale*, November 2002.

¹³Standard and Poor's Rating Service, U.S. Public Finance Rating Characteristics, March 7, 2008.

¹⁴Fitch Ratings, *Airports Rating Criteria Handbook for General Revenue, Passenger Facility Charge, and Letter of Intent Bonds*, March 12, 2007.

¹⁵Fitch describes "investment grade" and "non investment grade" thusly: "The use of credit ratings defines their function: 'investment grade' ratings (International Long-term, 'AAA' to 'BBB-'; Short-term, 'F1' to 'F3') indicate relatively low to moderate credit risk, while those in the 'speculative' or 'non investment grade' categories (International Long-term, 'BB+' to 'D'; Short-term, 'B' to 'D') either signal a higher level of credit risk or that a default has already occurred." Fitch Ratings, Rating Definitions, downloaded from the Fitch Ratings website January 19, 2009.



Source: Ricondo & Associates, Inc., Summary of Airport Bond Ratings and Other Key Data (as of January 2, 2009).
Prepared by: Ricondo & Associates, Inc., May 2009.

Exhibit 7. Senior lien airport bond rating distribution.

and the covenants and limitations the airport operator agrees to regarding the setting of rates and charges (rate covenant) and the issuance of additional debt. While this document sets forth the legal agreement between the airport operator and its bondholders, it does not establish the business arrangement of the airport operator; that is accomplished through the Agreement.

From the investor perspective, the Agreement provides the framework for how the airport operator will develop the resources necessary to meet its obligations under the bond indenture. The Agreement also establishes the responsibilities of the parties regarding the financial obligations of the airport and allocates the risks of running the enterprise. The major aspects of the Agreement in the eyes of the investment community include the rate-setting mechanism, the length of the Agreement, allocation of gate facilities and usage rights; and stipulations regarding the capital development of the airport, such as the MII provision.

6.2 Rate-Setting Mechanism

The rate-setting mechanism is a critical element in understanding the financial operations of an airport. In their respective rating criteria reports, both Fitch and S&P (Moody's does not have published criteria for U.S. airports at present) indicate they do not view a particular rate-setting methodology, be it residual, compensatory, or hybrid, as indicative of higher credit quality, but rather they look to the type of Agreement used in relationship to the airport's operating conditions.¹⁶

¹⁶Fitch Ratings, *Airport Rating Criteria Handbook for General Airport Revenue, Passenger Facility Charge, and Letter of Intent Bonds*, dated March 12, 2007; Standard and Poor's Rating Service, *Criteria: Governments: U.S. Public Finance: Airport Revenue Bonds*, June 13, 2007.

From the investor's point of view, the residual methodology provides a strong assurance of revenues, as costs are allocated to the airlines based on level of use. Thus, should one airline reduce service or leave a market, the costs are reallocated to the remaining airlines. This method has been tested at several airports, notably Pittsburgh International following the first bankruptcy and subsequent downsizing of the operations of US Airways; at Lambert St. Louis International Airport following American Airline's reduction of service after its acquisition of Trans World Airlines (TWA); and, most recently, at Cincinnati-Northern Kentucky International Airport as Delta retrenched in the marketplace. While the airports all retained positive cash flows and met their debt service obligations, the loss of service and decline in revenues was perceived as diminishing their resources and resulted in rating downgrades from the rating agencies. Still, the ratings remained solidly investment grade, acknowledging the cost recovery structure and economic underpinnings of the facilities.

The weaknesses of the residual method appear on the airport operator's balance sheet, as an airport is usually limited in the amount of excess cash it may generate. This stems from the airlines providing just the resources needed for airport operations on an annual basis and retaining cash resources on their own balance sheets. Furthermore, a residual airport's debt service coverage ratios tend to be lower, approximating the rate covenant in the bond indenture. Senior lien ratios may be higher due to the support of cash flows for subordinate debt, but the overall ratio will still be near the minimum required in the bond indenture. Also, the lack of excess cash results in higher capital costs and leverage as the airport operator has limited capital resources of its own to commit to a project, which also results in a greater use of capitalized interest during the construction phase of a development program.

In comparison, the compensatory method provides airport operators with greater control over their facilities and higher levels of cash. In exchange, the airport operator takes on a higher level of financial risk. In a compensatory business arrangement, the airport operator assesses rates to the airlines based on the cost of supplying facilities and services without consideration of non-airline revenues such as parking and concessions. In most instances, this allows the airport operator to capture non-airline revenue and use it for airport purposes, including funding of capital projects. This excess cash flow allows the airport operator to build larger financial reserves, post higher annual debt service coverage, and reduce borrowing costs by using internal resources and minimizing the need for capitalized interest. However, the airport generally has relatively weaker revenue guaranty protection compared with the standard residual methodology; thus, it can be a challenge to allocate costs in a timely fashion should an airline exit the market. Some compensatory Agreements may also lack a mechanism for supplementary year-end revenue requirements to balance airport financial operations or meet rate covenants. Therefore, the airport operator may experience more volatility in its financial operations, to the point of sustaining short-term financial operating loss, particularly in times of economic distress. In its 2008 U.S. Airport Sector Outlook: Six Month Update, Moody's points out that compensatory Agreements "... effectively create a cost-sharing requirement for the airport, forcing it to rely on passenger-related revenues to cover expenses. The airport [operator] must bear a greater risk from passenger declines as this will translate into lower revenues and leaner financial margins."¹⁷

Historically, most Agreements followed the residual model, particularly in the regulated era. Since deregulation, which enhanced the cyclical nature of the airline industry, airport operators have sought more control over their facilities with the compensatory or hybrid models becoming more accepted. Residual business arrangements are still prominent at airline hub airports, which allow the airport operator to pass the majority of operating costs to the airline(s) that place the most demand on the facility while also providing a measure of protection should the airline(s)

¹⁷Moody's Investor Service, 2008 U.S. Airport Sector Outlook: Six Month Update, August 2008.

falter. Compensatory approaches are favored at airports that are largely oriented to serving demand created by the underlying market and less reliant on any one airline. Hybrid business arrangements have been used at both airline hubs and O&D oriented airports. While a hybrid business arrangement can allow the airport operator to accumulate surplus funds at a higher level than a fully residual approach, the airport operator usually cedes some control over capital planning and shares some revenues with the airlines in exchange for the airlines' financial backstop—a balance of the “risk” versus “reward.”

6.3 Term of the Agreement

The investment community also pays close attention to the length of the Agreement in relation to the term of the bonds outstanding, as the need to periodically renegotiate the Agreement may result in changes to an airport operator's risk profile. Historically, Agreements ran for rather long terms, up to 30 years. The long terms were based on the regulated nature of the airline industry that existed through the late 1970s, the rather stable relationships that the regulations engendered between an airport operator and its tenants, and the perceived assurance the long-term commitments provided to investors that the airport operator would be able to repay its debt.

In the time since the deregulation of the airlines, the length of Agreements has shortened significantly, with many Agreements now running for just 5 years and several having rolling 30-day opt-out provisions. The shorter terms evolved in response to the increasing volatility in the airline industry as both airport operators and airlines sought greater flexibility to adjust their operations, and the Agreements that governed them, as economic conditions warrant. As S&P points out in its criteria piece, “Air carriers may not want to maintain service in an area generating intense interline competition or low yield. Conversely, airport operators want to avoid being saddled with unused terminal space resulting from tenant bankruptcy or routing changes.”¹⁸

Like the change to hybrid and compensatory Agreements, the shorter term provides an airport operator greater control over its facilities and reduces certain risks, such as the ability of a financially struggling airline to retain gates for competitive reasons at the expense of the airport. However, the shorter terms of the Agreements expose airport operators to the volatility of the airline industry to a greater extent as the Agreements need to be renegotiated more frequently, potentially at a time of extreme financial distress at the airlines. Furthermore, the shortened terms reduce the assurance that the costs of major capital projects will be recovered over time as an airline's obligations expire along with the Agreement, allowing it to leave before debt is retired (unless there is a separate agreement binding the airline to the repayment of a specific project) should competitive pressure, costs, or other factors deem a facility undesirable. The increased exposure to the volatility of the airline industry increases the importance of operating cash and other sources of liquidity on an airport operator's balance sheet as a means to absorb changes in cash flow without disrupting its financial operations and debt service obligations. Also, it places greater emphasis on management's ability to appropriately scale its capital program to the marketplace or risk placing too great a burden on its cost structure. Still, Fitch indicates that “. . . the flexibility afforded airports by the shorter duration of these Agreements often offsets (the risk associated with airline industry volatility).”¹⁹

¹⁸Standard and Poor's Rating Service, Criteria: Governments: U.S. Public Finance: Airport Revenue Bonds, June 13, 2007.

¹⁹Fitch Ratings, *Airport Rating Criteria Handbook for General Airport Revenue, Passenger Facility Charge, and Letter of Intent Bonds*, March 12, 2007.

6.4 Gate Assignments and Usage

Investors also consider the gate usage provisions of an Agreement to determine the efficiency of the terminal facilities, the ability of the airport to accommodate demand from the airlines, the potential need for capital expenditures to expand facilities, and the financial risk the airport operator faces regarding underused or unused gates in the event an airline reduces or eliminates service. The deregulation of the industry and the advent of the hub and spoke network raised awareness of the importance of the assignment of airport gates. Historically, most gates were assigned to an airline on an exclusive basis for the term of the Agreement. This largely reflected the joint venture arrangement with the airlines and the regulatory environment that guaranteed the airlines a return on their investment. This system worked well as routes were assigned by the government and competition was limited.

As the airline industry became increasingly competitive as the regulatory strictures were removed, the need for flexibility in gate assignments became apparent. As airlines eliminated direct service from non-hub cities, their need for gates at certain airports decreased. However, in some instances there were economic incentives for an airline to retain the gates to prevent competitors from entering the market. Thus, for an airport operator to accommodate a new entrant it may have been forced to build additional facilities that it may not need in the long term. At the other end of the spectrum, high demand airports found themselves unable to accommodate new airlines and service due to the exclusive nature of their leases, even if some gates were underutilized, also prompting a need for additional facilities.

At the prompting of the federal government, which wanted to promote competition through its grants, airport operators began to move to preferential and common-use gate assignments. For bondholders, preferential Agreements maintained some assurance of cash flow because an airline remains responsible for paying for the use of the gate while the airport operator gained the option of placing a second airline on the gate if needed, or to retake and reassign the gate if the incumbent airline falls below minimum usage requirements. Common-use provisions provide an airport operator almost complete control over its gate facilities, as any airline may be assigned to a gate at a particular time, though the airport assumes the risk related to unoccupied or underutilized gates.

The shift away from exclusive use gates, along with the adoption of compensatory pricing practices for terminal space, which tend to be higher than residual rates, serves to emphasize the effective use of these facilities. Also, the financial pressures placed on the airlines reduced their ability to absorb costs for underutilized assets. Thus, with the exception of a few airports that have significant grants of exclusive gates remaining, gate assignment provisions have generally shifted in a manner that provides greater control to the airport operators.

6.5 Capital Planning

The last major elements of interest to the investment community in the Agreement are the provisions governing the capital spending of the airport. These are important to understanding an airport operator's ability to undertake capital programs to address demands placed on its infrastructure, accommodate new entrants and service, and maintain its facilities to a satisfactory level for the traveling public. Major capital programs are complex, requiring extensive lead time to meet regulatory requirements, address political issues, and establish funding sources. Thus, airport planning is long term in nature. As a result, the plans of airport operators often run into opposition from the airlines, which are notoriously focused on the short-term cost due to the volatility endemic to the industry.

The key item regarding capital programs is the MII provision, which provides airlines input over the capital program. To balance risk versus control, residual Agreements typically have

strong MII provisions, from the airlines' standpoint, as the airlines provide the financial backstop to the airport's operations. A strong MII may limit the airport operator from taking on debt in certain circumstances, as the need for airline approval of projects could hinder the ability of the airport operator to implement certain capital improvements. Still, gaining the acceptance of the airlines is usually viewed as a favorable credit characteristic, because it demonstrates the airlines' commitment to serving a facility.

As airports operators have gained greater control over non-airline generated revenues, they have also sought to reduce airline control over capital programs. As Fitch notes in its criteria, "An airport [operator] that employs a compensatory Agreement may have taken on more responsibility for its financial operations and the risk of economic disruption than the airlines, thus it may be more appropriate for management to maintain greater control over its capital planning with a less restrictive MII provision or the absence of one entirely."²⁰ While this gives airport operators greater leeway in planning their capital programs, it also comes with the responsibility to assure the plans match the needs of the underlying service area, lest an entity become overburdened with facilities and debt. Thus, in these instances, investors are likely to pay greater attention to coverage generated by the airport's financial operations and the amount of liquidity and leverage held on the airport operator's balance sheet. Airport operators judged to be taking on leverage at a level higher than the market could support or that may prove unsustainable in the event of an economic downturn may see lowered ratings and higher interest rates as a result.

6.6 Limitations

While the Agreement is an important consideration in the making of an investment or rating decision, there are limitations in its application that are also evaluated. One limitation is that the Agreement provides assurance to bondholders only when it is in force. While airport operators may institute rates by ordinance upon the expiration of an Agreement, providing a means to continue generating revenue, the obligations of the airlines to the airport operator are greatly diminished while they gain the ability to leave the market with very little notice. In this situation, the airport operator assumes all the economic risk of the enterprise, a credit factor that is generally reflected in the rating and borrowing costs of the operator.

A second limitation occurs when an airline enters bankruptcy proceedings. The Agreement is usually treated as an executory contract, which a bankrupt airline must either assume or reject during its reorganization. In the period prior to making a decision to assume or reject the lease, the airline must fulfill its obligations under the Agreement following the date of the bankruptcy filing. If assumed, the airline must fulfill the terms of the Agreement in their entirety and make up any payments missed prior to filing for bankruptcy protection (pre-petition debt). If rejected, the airline must vacate its premises with the airport operator becoming a creditor of the estate with a claim based on the provisions of the bankruptcy code.²¹ While this is an either/or proposition, the airline may reject the lease and negotiate revisions in a new Agreement, that would then need the approval of the bankruptcy court.

There is a variation to this process, whereby the bankrupt airline assumes the Agreement in its entirety and assigns its interest to a third party that is willing and able to perform the debtor's obligations under the lease. An assignment may be allowed despite any limitations or prohibitions

²⁰Fitch Ratings, *Airport Rating Criteria Handbook for General Airport Revenue, Passenger Facility Charge, and Letter of Intent Bonds*, dated March 12, 2007.

²¹Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC, *Advisory, Public Finance and Bankruptcy, Analyzing the Impact of an Airline Bankruptcy on Airport Special Facility Revenue Bonds*, December 2002.

contained in the lease. As in a straight assumption, the debtor or the third party must cure all defaults and assure future performance.²² Use of this mechanism may result in an auction process, as the bankruptcy code allows other entities to enter counteroffers to ensure that an assignment attains the maximum resources possible to repay the bankrupt entity's debt.²³ Such a process occurred in American Trans Air's (ATA) 2004 bankruptcy, where AirTran Airways (AirTran) entered an agreement with ATA to purchase the debtor's gates at Chicago Midway Airport. When other airlines expressed interest in the gates, the court established an auction process through which Southwest Airlines offered a transaction that was accepted by the court as superior for ATA's creditors.²⁴ Should an auction process occur in a bankruptcy that results in liquidation after the debtor airline ceases operations, the facilities leased to the bankrupt airline may lay dormant until the court completes the auction process and the new airline begins operations.

Finally, while the Agreement provides the basis for the business arrangement of the airport, it does not guarantee that passengers will come through the door. As S&P points out in its criteria, "While use agreements may provide an additional level of comfort if a particular airline ceases to operate or alters its routing structure, the inherent demand in the air traffic market remains the ultimate security for the bondholder. A strong market will continue to attract airlines to serve that demand, while even the strictest use agreement will not, in and of itself, ensure the timely payment of debt service."²⁵

Investors and rating agencies focus on the core economic fundamentals of an airport as the major inputs in their respective assessments of an airport operator's credit status. As the Agreement plays a key role in turning these economic fundamentals into the resources that support the operation of the facility, airport operators should carefully evaluate how the Agreement aligns with the underlying demand from the service area and the operations of the airlines. Agreements that allow the airport to capture the resources generated by the service area in an efficient manner that benefits both the operator and the airlines serve to enhance the credit stature of an entity, while Agreements that do not align the interests of the market, operator, and airlines can undermine the credit fundamentals of an entity.

To assist both airport operators and airlines in the negotiation process and to recap much of what has been presented in this Part 2, Exhibit 8 presents a checklist of activities suggested to be completed before and during negotiations.

²²Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, PC, *Advisory, Public Finance and Bankruptcy, Analyzing the Impact of an Airline Bankruptcy on Airport Special Facility Revenue Bonds*, December 2002.

²³Fitch Ratings, *Chicago, Illinois: Chicago Midway International Airport (Rating Report)*, November 23, 2004.

²⁴Fitch Ratings, *Chicago, Illinois: Chicago Midway International Airport (Rating Report)*, November 23, 2004, and Fitch Ratings, *Fitch Comments on Southwest Airlines' Purchase of Chicago Midway Gates (Press Release)*, December 17, 2004.

²⁵Standard and Poor's Rating Service, *Criteria: Governments: U.S. Public Finance: Airport Revenue Bonds*, June 13, 2007.

PRIOR TO NEGOTIATIONS:

- ☐ Develop specific financial, operational, and developmental goals and objectives
- ☐ Prioritize the goals and objectives and group into "Needs" and "Wants"
- ☐ Identify any provisions in the current agreement that need to be revised, deleted, strengthened, or clarified in a new agreement
- ☐ Identify and prioritize any capital improvement program projects to be undertaken during the term of the new agreement, including assumptions for funding sources
- ☐ Review the allocations of expenses to cost centers to ensure they represent current operating focus of airport staff and are in the appropriate cost centers
- ☐ Develop the rates and charges formulas that quantify achievement of the goals and objectives identified earlier
- ☐ Review the proposed business deal with both bond counsel and financial advisor to avoid conflicting provisions with the bond resolution
- ☐ Communicate, as may be necessary, with the governing body of the airport prior to initiating negotiations with the airlines
- ☐ Prepare a term sheet containing key provisions of the new business deal
- ☐ Prepare the rates and charges document before initial meeting with the airlines
- ☐ Coordinate with the airline committee chairperson prior to initiating negotiations for a new agreement
- ☐ Forward any negotiation materials to the airlines at least 7-10 days prior to the scheduled meeting to review/discuss those materials

DURING NEGOTIATIONS:

- ☐ Continue to review revisions to the business deal to ensure that key goals and objectives are being achieved
- ☐ Draft the proposed airline agreement document
- ☐ Before circulating a draft agreement to the airlines, have the airport's internal/external counsel review the draft
- ☐ If desired, circulate the "boiler plate" articles to the airlines to initiate their review during negotiations of the business deal
- ☐ Develop the appropriate exhibits to the airline agreement for circulation to the airlines.

Source: Ricondo & Associates, Inc., September 2009.
Prepared by: Ricondo & Associates, Inc., September 2009.

Exhibit 8. Negotiation checklist.

PART III

ROADBLOCKS WE MAY ENCOUNTER

Discretionary and Surplus Revenue

7.1 Background

In the early years of formal agreements between airport operators and airlines, the vast majority of Agreements were long term, often running concurrent with the term of any outstanding bonds. They were also predominantly residual in nature to ensure that bond payments were essentially guaranteed by the air carriers. Residual Agreements generally include some type of MII provision that permits the airlines to approve or disapprove capital expenditures. The rationale behind such approval rights was to provide the airlines, which were responsible for making the airport whole, input into the net cost of any improvement that directly affects their rates, fees, and charges. Furthermore, as residual agreements provided for a year-end settlement to ensure airport operators recovered their costs and met their debt service obligations, any year-end surpluses were generally returned to the airlines through rebates or credits, thereby limiting the amount of cash held by airport sponsors.

With the ascendancy of compensatory/hybrid (compensatory) use and lease agreements, airport operators began to accept greater short-term risk and responsibility for their capital programs. As such, the ability of an airport operator to generate internal cash and hold reserves began to become an increasingly important consideration in terms of operations and ongoing capital funding. These resources serve two vital functions (1) to provide airport operators a source of internal capital (i.e., discretionary funding) and (2) to absorb short-term revenue short falls due to decreased activity (i.e., surplus cash).

Because it is generally not considered practical, efficient, or even prudent, to allow airlines to approve every single capital expenditure at an airport, airport operators may have some authority to incur capital expenditures based solely on management's judgment that an expenditure is appropriate. Thus, airport operators may seek to retain cash generated from non-airline sources as a means to internally finance necessary improvements without placing an additional burden on the airlines.

Surplus cash should be considered different than discretionary funding given the two different purposes. An acceptable level of surplus cash has always been a consideration for airport operators that operate under a compensatory agreement because under most such business arrangements, the airport operator generally bears the responsibility to make up any short-term revenue shortfall in its operation. To the extent that an Agreement does not allow an airport operator to promptly adjust airline rates and charges to recover its costs and meet its debt service requirements, an airport operator needs some amount of uncommitted cash to fund cyclical shortfalls and unforeseen events (e.g., unanticipated repairs or uninsured damages) as well as catastrophic changes in the nation's transportation network, such as occurred in the immediate post 9/11 era.

The issues regarding discretionary and surplus funds boil down to the level of spending that the airport operator is permitted to incur without first obtaining consensus agreement from its

airline tenants and the level of uncommitted or unencumbered cash that an airport operator has at its disposal.

Impacts to both airport operators and airlines are discussed in the following sections:

7.2 Impact on and Importance to Airport Operators

Airports can be complex businesses that must financially stand on their own and require significant amounts of capital investment in infrastructure. It is important for an airport operator to have a reasonable level of cash available to fund fluctuations in operations as well as for planning purposes and capital needs. It is also important to note that an airport operator is generally planning for a longer-term horizon than its airline tenants. This can become an issue in determining the overall need for a certain project.

During the economic downturn that began in late 2007 and accelerated through 2008 and into 2009, many airport operators needed to use reserves (or surplus funds) to cover certain expenses or to provide rate mitigation to the airlines as passenger activity, and thus revenues, contracted. While not a requirement, the bond rating agencies generally look favorably toward an airport operator that has higher levels of unrestricted funds. While the rating agencies do not specify a particular level of cash needed to support an airport operator's rating, their criteria indicates maintaining an adequate level of cash on hand is an important rating factor. As with any business, airport operators must have funds available to cover downturns, minimize the need for borrowing, and react to opportunities in an efficient and timely manner.

7.3 Impact on and Importance to Airlines

Airlines feel that most any expenditure, directly or indirectly, has an affect on their rates, fees, and charges at an airport. Airlines do, however, recognize the need for airports to have some amount of independent spending authority as well as some level of reserve funds available. Airlines simply strive to minimize those amounts to levels that they feel are adequate. While the perceived level may vary from airport to airport, airlines like to maintain control over as much of the surplus funds as possible.

Limiting levels on discretionary and surplus funds is of particular interest or importance to the airlines because these funds are derived either from direct contributions incorporated in airline rates or by funding from non-airline sources that might otherwise be available to credit airline rates, fees, and charges. In compensatory Agreements, these funding levels are also important to the airlines, but the method of funding these accounts may not affect rates, fees, and charges if they are funded from non-airline sources of revenue. In any case, airlines will promote their view that airports do not need to accumulate excessive levels of cash reserves because it imposes a cost, either through higher rates and charges or through reduced return on investment.

7.4 Various Alternatives for Treatment in Agreements

Each airport operator must evaluate its own specific situation. Different levels of funding are likely to be required at different sized airports and can be dependent on the type of Agreement in place, whether or not an airport is primarily an O&D market versus a connecting hub, the reliance on one carrier or a small group of carriers for the majority of its passenger volume, age of its infrastructure, its ownership (which can affect its efficiency or ability to access outside funding), and airline costs compared with alternative opportunities that airlines might have available.

Alternative funding treatments in airline agreements may include the following:

- An annual amount included as a line item in the budget to fund the accounts
- Funding from debt service coverage collected on general airport revenue bond debt service payments
- Funding from non-airline revenue sources (e.g., parking revenue)
- Replenishment through rates for actual amounts expended each year
- Retention of all revenue in the airport's "bottom" fund, often called the general purpose fund

Funding ceilings may also be treated in different manners:

Specific annual amounts agreed to in the airline agreement

Replenishment of expenditures until the fund balance reaches a specified maximum balance

No limit or ceiling specified

There are also potential different methods of identifying these funds and their uses:

- Discretionary and surplus funds might not have any limit on use.
- Airports may or may not include a return on investment equal to their cost of borrowing when amortizing reimbursement payments from the airlines. Even with a return on investment, the end cost of using funds that are internally available is less expensive than the annual debt service resulting from the issuance of general airport revenue bonds given the associated transaction costs associated with a bond issue.
- Funds may be divided among two or more accounts for (1) airline supported projects and (2) airport supported projects.
- Return on investment may not be included in recovery of funds on deposit in an airline discretionary account.
- Airport only includes return on investment on airline requested projects when funding comes from the airport account not the airline account.

7.5 Linkages to Other Agreement Provisions

- Types of rate-setting methodologies—how airlines contribute to discretionary and surplus funds (see Section 2.3).
- Capital program requirements and control—what type of flexibility does the airport operator have to use discretionary and surplus funds for capital improvements (see Section 4.4 and Chapter 8).



CHAPTER 8

Capital Project Control and Consultation

8.1 Background

Capital project control and consultation is typically an issue that will surface in most Agreement negotiations between airlines and airport operators. Some Agreements address this issue through an MII provision. This provision will generally indicate how much control (if any) the signatory airlines have over an airport operator's capital development program, and will detail the formal procedures for how such controls are executed. Capital project control and consultation provisions vary considerably, ranging from no control to very strict and structured airline control. There are also numerous variations in between. Since the airlines bear the financial risk, more airline capital development control generally occurs as Agreements become more residual in nature.

Before the deregulation of the airline industry in the late 1970s, Agreements were generally long term and were considered the primary financial security for an airport operator's revenue bond debt. Before deregulation, Agreements were in many cases coterminous with an airport operator's 30-year revenue bond debt. Given the financial security provided by the airlines, many of these Agreements were also set up with a residual rate-setting methodology where the airlines assumed the financial risk for the airport financial operation. Because of this financial risk and the potential cost exposure that larger capital programs can present, the airlines have historically sought controls over airport operator capital spending. Also, because of varying and evolving airline business models and perspectives, there can also be disagreements regarding "what is the right type" of airport capital development. As such, capital development and control continues to be a significant issue for airlines and airport operators.

Since deregulation of the airline industry, the following trends have impacted the treatment and relevance of airline capital project controls at airports:

- Airport operators have trended away from residual-type rate-making approaches in their Agreements and, in many cases, may rely more on non-aeronautical revenue sources for capital development.
- The length of Agreements has decreased from the historical 30-year terms to shorter durations such as 5 years or less.
- The concept of pre-approval of airport capital development programs within Agreements has gained some prominence.

It could be argued that, in general, these trends have somewhat reduced airline financial exposure to capital program costs; however, airline rates and charges still remain a critical funding source. As trends have changed, so have the types of Agreement provisions addressing capital

project control and consultation. These provisions vary widely from airport to airport depending on the individual situation.

The impacts on both airport operators and airlines are discussed in the following sections; along with recent trends, treatments, and linkages of the capital project control and consultation provisions with other critical airport operator/airline negotiation issues.

8.2 Impact on and Importance to Airport Operators

An airport operator is charged with meeting the aviation needs for its local community or region, and as such, has a staff of professionals to analyze, plan, and implement capital development programs. Additionally, an airport operator is required to perform certain analyses and studies of its capital program for its development to be in compliance with and eligible for FAA grant funding, passenger facility charges, or other state or local funding. Meeting these various obligations and planning for capital development that meets the needs of the surrounding community's current and future aviation demand requires careful coordination and planning. Thus airport capital planning is a very challenging undertaking because of the very dynamic nature of the aviation industry combined with the fact that large airport capital projects almost always take several years to plan, develop, and implement.

Given these factors and the required planning process, airport operators generally take a longer-term view of their CIPs. It is commonplace for an airport operator to have a forward-looking 5-year CIP, moreover, those that have completed master plans and have an FAA-approved airport layout plan (ALP) have capital development programmed out 10 to 20 years into the future. Airport operators will find that their planning horizon is typically much longer than that of their airline partners, which can become an issue in seeking agreement on certain development. This issue is also very apparent during times of an economic downturn for capital projects that can take several years to implement. For instance, an airport operator may want to start the process for planning the development of a terminal expansion that will not be operational until 3 years from now. However, this expansion may be a tough one to sell to the airlines that have currently cut back on their capacity and are seeing current decreases in numbers of passengers.

Given the many steps it can take for an airport operator to develop a capital program that has buy-in from its various stakeholders including, but not limited to, its airline partners, the local community it serves, and the FAA, too much control by any one stakeholder can become or at least be perceived as an issue. For example, it is important for the airport operator to understand the impacts on competition that could arise if facility expansion opportunities are limited to meet demand from new entrant or expanding incumbent carriers. Other issues airport operators can face when dealing with airline control are the differences in preferences among the airlines and, for some smaller airports, the attention from airlines to their capital programs.

In most cases, the capital program that is developed at an airport becomes the responsibility of the airport operator, who must operate and maintain it for the current airport tenants. If the airport becomes "over-built," it could become very costly for airlines to operate there and, thus, future air service could be compromised. On the other hand, if the airport operator does not keep its infrastructure on pace with demand, operational delays at the airport could become more frequent, and could also result in decreases of air service due to the declining level of service offered. Therefore, airport operators are faced with very important, yet difficult challenges when planning for future capital development. As such, many airport operators may be less inclined to compromise on control over their capital development programs.

8.3 Impact on and Importance to Airlines

The primary importance to airlines regarding MII provisions is the ability to have some controls over capital spending at airports. All things considered, airlines need to achieve long-run profitability in an extremely competitive and dynamic industry to have a sustainable operation. While airport costs as a percentage of total airline operating costs may not be as considerable as some other expense categories such as fuel or labor, they are still significant enough to warrant attention. For First Quarter 2008 (using Air Transport Association of America's Airline Cost Index based primarily on U.S. DOT Form 41 data), the categories of non-aircraft rents and ownership and landing fees combined constituted approximately 6.2 percent of U.S. domestic carrier operating costs.²⁶ It should be noted, however, that the expense category of "non-aircraft rents and ownership" also includes the cost of hangars, ground service/support equipment (GSE), storage and distribution equipment, and communication and meteorological equipment that may or may not necessarily be included as part of an industry standard for calculating airport costs.

Airport capital development that does not effectively promote efficient movement of passengers through an airport can be detrimental to both the operational and financial ability of airlines to serve a specific market. While airport operators have dedicated professional staff for the planning and development of capital programs, the airlines are important stakeholders, and it is suggested that their input be considered because they are, in many cases, the primary users of facilities related to the terminal and airfield areas.

At many airports, especially those with residual-type rate-setting approaches, the airlines provide an overall financial guarantee to the airport operation. Therefore, as a tradeoff, some degree of airline control over capital development and spending is typically deemed to be warranted. Without any controls and as parties to a residual-type Agreement, the airlines could potentially be at the mercy of the airport operator for costs related to capital projects that the airlines may view as not needed or even politically driven. This type of risk tradeoff is generally not acceptable to the airlines. Depending on how the rate-setting methodology is structured, at non-residual Agreement airports with shorter Agreement terms, capital project control may be viewed as somewhat less important compared with a residual Agreement airport. However, airlines as critical stakeholders will still be interested in the capital projects that will be implemented, because in most cases the core group of airlines plans to operate at that airport beyond the term of the Agreement.

8.4 Various Alternatives for Treatment in Agreements

In summary, the treatment of capital control and consultation provisions in Agreements is dependent on the overall nature of the airline rate-setting methodology. For example, an Agreement where the airport operator is taking most of the financial risk may have limited to no airline control over capital development. However, for a more residual-type business arrangement, an Agreement generally contains a stricter application of these types of provisions. With many Agreements falling somewhere in between compensatory or residual, there are various ways Agreements can treat capital consultation, control, or MII provisions that are consistent with the level of risk each party is assuming. The following represent various treatments, if applicable, for structuring a capital control or MII provision in Agreements:

²⁶Passenger Airline Cost Index, Air Transport Association, <http://www.airlines.org/economics/finance/Cost+Index.htm>, accessed June 2009.

MII Thresholds

MII Thresholds should be set strategically based on the market share specifics of the market:

- Double-barrel—a certain number of airlines representing a certain amount of activity threshold must be met (e.g., 50 percent of airlines in number representing 60 percent of landed weight).
- Single-barrel—an activity level **or** number of airlines threshold must be met.
- Cost center-specific—multiple thresholds are established based on the cost center which is impacted by the project (e.g., enplanement or fee activity for terminal projects, and landed weight or fee activity for airfield projects).

Types of MII Provisions

- “Affirmative” or “Positive” MII—the airport operator is required to receive the threshold of “affirmative” or “yes” votes from the signatory airlines to obtain approval to proceed with a capital project.
- “Negative” MII—the airport operator has approval to proceed with a capital project unless it receives the appropriate threshold of “no” votes from the signatory airlines.

Types of Control over Capital Development

- Absolute disapproval—the airport operator may not undertake the capital project during the term of the Agreement unless it receives approval from the signatory airlines.
- Rate-base disapproval—the airport operator may not fund the capital project through airline rates and charges during the term of the Agreement unless it receives approval from the signatory airlines.
- Deferral—if the airport operator does not receive approval from the airlines to undertake the capital project through the MII process, it may undertake the project after a certain agreed-upon period of time has passed (e.g., 1 year, 6 months).

Processes for Airline Consultation

An airport operator may be required to do one or more of the following:

- Conduct meeting with signatory airlines to present project
- Provide written justification for capital project
- Provide cost estimates and funding plan for capital project
- Provide drawings and time schedule for capital project
- Estimate the financial impacts to the airlines resulting from the capital project (including impacts to capital costs, operating expenses, and non-airline revenues)
- Allow certain period of time for signatory airlines to assess capital project and submit MII vote (e.g., 2 weeks, 30 days)

Capital Project Exceptions from MII Process Included in Some Agreements

- Safety and security projects or those of an emergency nature
- Projects mandated by the government
- Projects to settle claims or lawsuits, satisfy judgments, or comply with judicial or administrative orders
- Projects with capital costs less than a certain level
- Projects to repair or replace airport property damaged or destroyed by fire or other casualty
- Projects funded entirely from sources other than airline rates and charges (e.g., FAA AIP, PFCs, airport operator discretionary funds)
- Projects pre-approved per the Agreement

8.5 Linkages to Other Agreement Provisions

- Cost centers—how capital projects are linked to cost centers for airline rates and charges (see Section 4.3).
- Types of rate-setting methodologies—how the rate-setting methodology may impact the type of MII provision (see Section 2.3).
- Capital program requirements—additional information on airport capital development programs (see Section 4.4).
- Discretionary and surplus revenue—types of funding for capital projects relating to the MII process (see Chapter 7).
- Signatory status—which group of airlines is permitted to participate in the MII process (see Chapter 10).

Facility Control

9.1 Background

The leasing and use of terminal resources has always been a critical element of the business and operating relationship between airlines and airport operators. Years ago, it was more commonplace for an airline to lease more terminal space than it may have needed for its actual operation, because this gave an impression to the traveling public of the airline being larger and more successful than its competitors. It also helped prevent competing airlines from being able to lease or use more terminal space, thereby limiting the competition for passenger traffic at an airport.

However, as passenger traffic continued to grow, particularly in the years after the 1978 passage of the Airline Deregulation Act, increased use of terminal facilities put additional pressure on terminal capacities, necessitating expansion of these facilities at airports across the country. Before the introduction of PFCs in the early 1990s, these expansions typically required the issuance of general airport revenue bond debt due to the limited availability of other types of funding sources. This increased the costs to the airlines through increased annual debt service, and in many instances debt service coverage, in the terminal rate base. There were not many options for avoiding this type of situation, as many Agreements were long-term 30-year agreements, and the terminal facilities leased by an airline were generally leased on an exclusive-use basis.

Before airline deregulation, it was typically considered additional security by the investment community when terminal facilities were leased on an exclusive-use basis for a long term, generally coterminous with the revenue bond issue. However, airlines became less able to obtain long-term agreements with airport operators as the investment community began to recognize that the real security for airport revenue bond debt was the underlying economic strength of the market area the airport served, and as airports began to obtain favorable financing rates without long-term airline commitments. After years of airline bankruptcies in the 1980s and 1990s, which tied up gates and other facilities in the terminal, airport operators began negotiating to lease their facilities on a preferential and common-use basis when Agreements expired.

An additional impact of increased passenger traffic in the post-airline deregulation era was a broadening of the types of airlines serving those passengers. The introduction of LCCs often further aggravated terminal facilities constraints, as the markets with the greatest increases in this type of passenger activity also saw the largest demand for additional facilities in their terminals. These constraints were not strictly limited to the terminal itself, but also included aircraft parking, particularly overnight parking at many airports. And, with most, if not all, of the facilities being currently leased by incumbent airlines, the ability to make room for other airlines became extremely difficult. When airport operators planned their respective expansion programs, there was an increased interest in building an extra gate or two to provide space that the airport operator could lease (or charge on a per-use basis) to expanding incumbent or new entrant airlines.

In October 1999, responding to concerns that new entrant airlines were having difficulty gaining access to critical facilities, particularly at certain heavily used airports, the U.S. DOT issued a report titled “Airport Business Practices and Their Impact on Airline Competition.” This report provides information to airport operators on airport business and leasing practices that may enhance opportunities for airline access. Building on this report, in 2000, the Wendell H. Ford Aviation Investment and Reform Act for the 21st Century (AIR-21) requires the submission of a written Competition Plan to the FAA by large and medium hub airports at which one or two carriers control more than 50 percent of the passenger boardings (covered airports) for a new PFC to be approved for collection or a grant to be issued under the AIP. According to AIR-21’s legislative history, the purpose of these Competition Plans was for covered airports to demonstrate how they would provide for new entrant access and expansion by incumbent carriers.

As exclusive use leases were replaced, in part, with preferentially and jointly leased facilities, airport operators and airlines had to address such issues as controlling usage on preferentially leased facilities; how to charge for usage at a gate that was on a per-turn basis; arriving at the appropriate methodology for charging for joint use facilities; providing stability for airlines leasing preferential-use gates yet allowing for usage by other airlines; how an airport operator could recover a gate from an airline that was underutilizing it; permitting and charging for, where appropriate, ground handling of an airline’s activity on a non-leased gate; permitting and charging for overnight usage and parking of aircraft at gates not leased by that airline; and ensuring that all costs were borne by the appropriate users and tenants.

9.2 Impact on and Importance to Airport Operators

The airport operator typically seeks the ability to manage and control its facilities to maximize usage; provide for a constant revenue stream; and control the need for additional expansion unless absolutely necessary. The airport operator prefers to serve as the “landlord” over the facilities, yet must also acknowledge that the airlines need to be able to operate their flights and have assurance that gates and other facilities will be available for the handling of passengers and baggage. While there has been a transition to more preferential space in airports at airline premises, the airport operator should be willing and able to enforce the accommodation provisions in its Agreement to achieve the results that having preferentially leased space provides.

9.3 Impact on and Importance to Airlines

An airline’s primary interest is in having the necessary and appropriate facilities available to handle its flights and process its passengers at an airport at a reasonable cost. Airlines are continually evaluating whether it is more efficient and effective to use facilities on a per-turn basis rather than lease that particular facility for the term of the Agreement. It is challenging for airlines to strike a balance between providing flexibility in the use of an airport’s terminal facilities and controlling costs.

9.4 Various Alternatives for Treatment in Agreements

Many provisions in recently negotiated Agreements are allowing airport operators to manage and better control usage of terminal facilities, while permitting incumbent airlines to continue to operate their respective schedules without the fear of frequent disruptions. Inclusion of preferential-use provisions in Agreements may permit the airport operator to relocate an incumbent airline if

that airline is not maintaining a minimum amount of activity on a gate (“minimum use” requirements). There are often Agreement provisions that address handling of aircraft by other airlines and third-party providers, and for managing potential airline subleases of their facilities to another airline.

Another approach that is commonly being included in Agreements is the leasing of terminal facilities on a common-use basis. While not recommended across the board, this approach has addressed capacity issues and concerns at certain airports through improved management of existing terminal facilities rather than construction of additional facilities to provide for the increases in both passenger and airline activity. This approach has produced a number of concepts for managing and controlling usage of limited terminal facilities, including CUPPS (Common Use Passenger Processing Systems) and CUSS (Common User Self-Service) kiosks.

Essentially, these recent approaches and Agreement provisions related to controlling the use of terminal facilities are prompted primarily by the desire to limit the need for rushing into terminal expansion projects while ensuring that the airlines are able to handle and process their passengers at a level of customer service satisfactory to both the airlines and the airport operator. At that point, focus on cost impacts shifts from dealing with a major capital program to determining how the existing terminal costs are spread throughout the terminal facility and what formulas determine how all tenants and users of those facilities are assessed.

9.5 Linkages to Other Agreement Provisions

- Joint use formulas—how costs of common use facilities are distributed among the users (see Chapter 12).
- Signatory status—minimum use requirements for gate and ticket counter space to maintain signatory status (see Chapter 10).

CHAPTER 10

Signatory Status

10.1 Background

Airlines began executing long-term Agreements during the era when the airlines were subject to regulation by the Civil Aeronautics Board. During that same period, airport operators first gained access to the municipal bond market as a method to fund capital improvements. The financial health of a certificated airline was relatively assured, thus the credit associated with an airport operator's issuance of municipal bonds centered more on air service than on the economics and demographics of the airport's air trade area to sustain service. For that reason, the financial markets looked for commitment from the airlines that they planned to operate at the airport and pay fees in accordance with the Agreement for the full term of any outstanding bonds.

Signing a long-term Agreement signified a commitment to the market and a revenue stream to the airport operator in return for lower fees being charged to the signatory airlines than to those airlines not willing to commit for an equivalent period of time. In view of that, non-signatory airlines, then and now, usually pay higher landing fees and rents than do signatory airlines.

In October 1978, the Airline Deregulation Act partially shifted control over airline traffic from the federal government to the marketplace and resulted in a fundamental shift away from regulation toward an air transportation system that relied on competitive market forces to determine the quality, variety, and price of air services. Airlines have found that they have had to operate in a more business-like fashion and retain flexibility to enter and leave markets that do not produce sufficient revenue to support their network's operations. The term of Agreements has generally decreased from the 30-year terms to 15- and 10-year terms and then to terms of 5 years or less, depending on the market being served. The credit markets now focus on the economic climate and the demographics of an airport's air trade area (as discussed in Section 6.1). Under the assumption that there are numerous airlines operating that are flexible enough to react to varying levels of demand, less of an emphasis has been placed on the airlines serving the market than had been in the past. However, a strong mix of airlines that are signatory to an Agreement is still considered a plus by the credit market. Further, at an airline hub, the credit market reacts positively to a longer term Agreement.

10.2 Impact on and Importance to Airport Operators

While airport operators highly desire obtaining airline commitment to the local market, they recognize that airline networks are very complex and that airlines have a need to maintain flexibility in a market, whether it is by varying fleet mixes owned by themselves or operated by affiliate airlines or other business partners, or to cease all operations in a market at any point in time. If an airline is signatory to an Agreement at an airport, but decides it is not viable to continue serving the local market, the fact that the airline has a contractual commitment to lease space at

an airport could have little, if any, affect on making a decision to cease operations and vacate its space at the airport. The departing airline will either seek to sublease its space or continue with lease payments even though it no longer serves the market. Thus, airlines often want to limit the term of their signatory status at an airport in order to reduce exposure to future liability.

Obtaining signatory commitment from airlines is generally more important to airports that are situated in a weak economic location, airports that serve as airline hubs, airports that have only one or two airlines serving the airport, or airports that calculate their airline rates and charges using an airport residual rate-setting methodology. Airports situated in a stronger business locale, having diverse air service, and calculating airline rates and charges on a compensatory or hybrid basis are less likely to be concerned about which airlines are signatory to an Agreement. In some cases, an airport operator may feel that it is diverse enough that airline commitment may not cause any significant benefit to the credit markets and may not even offer an Agreement for consideration by the airlines.

Most Agreements contain provisions that allow the airport operator to reconcile the airlines' actual financial requirement at year end with what was paid for the year and collect any shortfall in revenue from the signatory airlines. Depending on the type of rate-setting methodology used, this reconciliation will pertain to specific revenue and cost centers or to the entire airport system.

Obtaining signatory commitment from non-hubbing airlines may be important to the operators of airports that serve as connecting hubs for particular airlines. The airport operator likely has significant liability related to ongoing maintenance and debt service on facilities constructed for the benefit of the hubbing airline's connecting passengers, as well as support operations that would not be necessary if the airport were to need only facilities to serve the local market. History shows that airlines have shut down or relocated hub operations without significant regard to the resulting economic effect on the airport. In the case of a commitment to a large amount of space, the continuation to pay the cost of abandoned facilities for as long a term as possible can be valuable to a hub airport.

The business deal contained in the Agreement might also provide the airlines with some form of approval rights on certain types of capital projects at the airport, generally contained in an MII provision of the Agreement. Depending on the operating philosophy of an airport operator, such a provision may be either desirable or not.

To limit airline approval rights on appropriate expenditures and to determine which airlines are granted the lower signatory rate structure, airport operators have developed signatory requirements as well as various classes of signatory airlines.

10.3 Minimum Requirements

Airport operators typically allow any airline with a request to lease ticket counter, operations, and gate space for the full or remaining term of the Agreement to be signatory to the Agreement. Airport operators that lack a particular category of space or that want to permit scheduled charter airlines to pay the signatory rate may make adjustments to the basic requirement that airlines lease space sufficient to handle their complete operations.

Sometimes an airport operator has ticket counter space available, but not a sufficient number of gates to permit leasing of a gate to an airline desiring to commit to the term of the Agreement. In these cases, the requesting airline will share gates under a sublease or preferential use provision and the definition of "Signatory Airline" will include a minimum amount of square feet that must be leased (generally an estimate of the square feet necessary for the number of ticketing positions and support space needed to support its operation). In most cases, in exchange for benefiting from

the signatory rates, the airport operator's objective will be to obtain the largest commitment it can reasonably expect from the requesting airline.

10.4 Treatment of All-Cargo Airlines

Because all-cargo airlines do not have a need for space in an airport terminal building, they may not execute the same Agreement as the commercial passenger airlines that are limited to carrying belly-cargo. At some airports, the all-cargo airlines execute the same Agreement and all references to terminal requirements and fees simply do not apply to them. On the other hand, they might execute an operating agreement that commits them to paying fees, carrying appropriate insurance, indemnification, and other legal and regulatory matters. They may also have a ground lease or other building lease for support of their operation.

The Agreement signed by the passenger airlines will often permit the all-cargo airlines to benefit by paying signatory fees if they provide a minimum level of landed weight at the airport and lease space from the airport operator for a term at least as long as the term of the passenger airlines' Agreement. If the Agreement contains an MII clause, the all-cargo airlines' approval participation is generally limited to matters pertaining to the airfield.

10.5 Classes of Airlines

Classes of airlines can include mainline airlines, affiliate airlines, all-cargo airlines, and scheduled charter operators (more often, scheduled charter airlines are not granted signatory status). An affiliate airline is usually not signatory to the Agreement if its mainline airline or a different affiliate of its mainline airline leases space at the airport and executes the Agreement on the affiliate's behalf. At some airports, the affiliate airline may be granted signatory privileges for rates and charges if the mainline airline or different affiliate airline agrees in writing to guarantee its payment of all rates and charges, including passenger facility charges (for further discussion of affiliates see Chapter 13).

10.6 Rights and Privileges

Airlines with signatory status generally pay the lowest rates available to airlines serving the airport. In return, they are assured specific premises in the terminal building from which to operate. They can also be granted the right to handle their affiliate airlines without any additional permits or ground handling fees.

If, at the end of the year, the Agreement calls for a distribution of shared revenue or a refund, the signatory airlines receive the benefit of a further reduction in cost to operate at the airport. However, if there is an unanticipated shortfall, they will pay the necessary amounts to eliminate the shortfall.

Signatory status may provide for airline review and comment on an airport's operating and capital budgets. It may include rights, subject to the MII formula, to disapprove or defer the undertaking of a capital project or inclusion of a certain cost as part of its rate base and to participate in the planning of airline facilities.

10.7 Impact on and Importance to Airlines

An airline's major benefit in obtaining signatory status is to ensure that it is charged the lowest rate at an airport and is positioned to receive any revenue that is shared with the airlines. Being signatory will also preserve adequate space for its operation (except in instances where

shared use is being required for a temporary period) and may provide a level of control over airport expenditures that impact its rates.

The airlines that are signatory want to ensure that any other airline receiving the benefits of signatory rates, rights, and privileges has also made a financial commitment to the airport at least equal to the investment it has made. Scheduled airlines may be less sympathetic than airport operators are about granting signatory status to non-scheduled and international airlines.

An airline that wants to test the market or wants freedom to leave without the requirement to continue paying rent for leased premises must weigh the incremental cost of non-signatory fees against the flexibility it desires. Sometimes, airlines may decide to execute the Agreement after they have operated for a period of time sufficient enough to provide confidence in the market and the ability to produce the necessary revenue to support its operation.

10.8 Various Alternatives for Treatment in Agreements

Signatory treatment is relatively consistent in Agreements, generally with the objective of obtaining a financial commitment for the term of the Agreement that is as large as possible. Alternatives or modifications to the standard requirement to lease space (ticketing, operations, and gate) sufficient for its operations include the following:

- At airports where no gates are available, limiting commitment to ticketing and support space
- Allowing scheduled charters and international airlines to pay signatory rates
- Allowing all-cargo airlines to execute the Agreement and benefit (partially) from the signatory benefits
- Varying MII formulas—discussed in Chapter 8

10.9 Linkages to Other Agreement Provisions

- Affiliates—how can an affiliate attain signatory status (see Chapter 13).
- Capital project control and consultation—the type of control signatory airlines have over the capital development process (see Chapter 8).
- Facility control—what facility control provisions are signatory airlines subject to, for example, minimum use requirements for gates (see Chapter 9).
- Airline rates, fees, and charges—how signatory and non-signatory airlines pay for their use of the airport (see Section 2.3 and Chapter 11).

CHAPTER 11

Terminal Rental Rate Methodologies and Considerations

11.1 Terminal Rental Rate Divisors and Methodologies

There are a number of methodologies employed at airports to calculate terminal rental rates, each with their own set of reasons and implications pertaining to their use. In general, the terminal rental rate methodology used revolves around the following considerations:

- Balancing airport/airline risks and rewards
- Balancing overall airline costs versus the airport's financial performance
- Maximizing the use of terminal space
- Maintaining level of cost recovery

Generally, these various factors are quantified in the three primary approaches to establishing terminal rental rates as follows:

- Compensatory rental rates
- Commercial compensatory rental rates
- Residual rental rates

To best understand the various terminal rate-setting methodologies and their implications, it is best to first understand the different rental rate divisors (measured in terms of square feet) that are primarily used throughout the industry. The following provides a general definition of the rental divisors used and the individual components of terminal space that are included within each.

- **Useable Terminal Space:** Useable terminal space is defined as the gross square foot area of the terminal, less the mechanical and electrical area and voids within the terminal. As a general rule, airport administrative space is usually included within the definition of useable space, with the understanding that airport administrative space could otherwise be used if it were not occupied by the airport operator. In some cases, however, airport administrative space may also be excluded from the definition of useable terminal space.
- **Rentable Terminal Space:** Rentable terminal space is defined as all space within the terminal that can be rented or leased to any airlines or other tenants. As such, rentable terminal space includes total airline space, terminal concessions space, and other rentable space within the terminal, and specifically excludes public circulation areas, restrooms, voids and mechanical and electrical areas. Rentable terminal space can also include space for airline ticket counter queuing, airport administrative space, rental car counter queuing, as well as space for the TSA offices and the footprints for EDS machines.
- **Airline Leasable Space:** Airline leasable space consists of all space within the terminal that is available for occupancy by an airline.
- **Airline Leased Space:** Airline leased space consists of all space within the terminal that is occupied and leased by an airline, but excludes vacant, or unleased, airline space. In general, airline space consists of airline offices, ticket counter, baggage claim, inbound and outbound bag

make-up areas, operations areas, hold rooms, and aircraft gates. In many cases, the ticket counter queuing area in front of the airline ticket counters is also included within the airline's leased areas.

Table 4 provides a summary of the various terminal space components that are included within the definition of each terminal space divisor.

The primary rental rate approaches are described in greater detail as follows:

- **Compensatory Terminal Rental Rates**

A compensatory rate-making approach represents a cost-based approach, in that an airline pays only for the cost of terminal space that it leases or uses. Under a compensatory rental rate methodology, a useable space divisor calculates the average terminal rate per square foot. By using a useable space divisor, total costs are effectively spread across all terminal space, including airline, concessions, public space, and other space. As a result, the space divisor is larger and results in a lower average rental rate. Since the airlines pay rent on only the space that they lease, the airlines are not responsible for covering the costs associated with the other areas of the terminal—namely terminal concessions, public, or airport administrative space. As a result, the airport operator and revenue generated from the terminal concessions must cover the costs associated with other space, including vacant airline space. With a compensatory terminal methodology, the airport operator not only bears the risk of ensuring that terminal concession and other tenant revenues cover the costs of the remaining space within the terminal, but also bears the risk of any vacant airline space.

- **Commercial Compensatory Terminal Rental Rates**

A commercial compensatory approach is consistent with the methodologies employed at commercial retail buildings with multiple tenants and large public or common areas such as shopping malls. Similar to the compensatory approach, a commercial compensatory rate-making approach represents a cost-based approach. However, under a commercial compensatory

Table 4. Terminal space divisors.

Terminal Space	Terminal Space Included In Divisor			
	Useable	Rentable	Airline Leasable	Airline Leased
Leased Airline	•	•	•	•
Vacant Airline	•	•	•	
Ticket Counter Queuing	•	○	○	○
Concessions	•	•		
Other Rentable	•	•		
TSA / Security Offices	•	○		
EDS Machine Footprint	•	○		
Airport Administrative	•	○		
Security Checkpoint	•			
Public	•			
Restrooms	•			
Mechanical/Electrical				

Notes:

- = Space component is usually included as part of the overall definition of the terminal space divisor.
- = Space component is sometimes included as part of the overall definition of the terminal space divisor.

Source: Ricondo & Associates, Inc., May 2009.

Prepared by: Ricondo & Associates, Inc., May 2009.

approach, the airlines, concessionaires, and other tenants are allocated their pro-rata share of the costs of the public or common areas and administrative areas. With a commercial compensatory rental rate methodology, a rentable space divisor is used to calculate the average terminal rate per square foot.²⁷ By using a rentable space divisor, total costs are effectively spread across only the airline, concessions, and other rentable space. As a result, the space divisor is smaller and results in a higher average rental rate. Under this methodology, the airport operator is not responsible for covering the cost of the public or administrative space, and revenue generated from the terminal concessions must cover the remaining total costs of the terminal. With a commercial compensatory terminal methodology, the airport operator still bears the risk of any vacant airline space within the terminal.

- **Residual Terminal Rental Rates**

A residual rate-making approach assumes that the airlines pay any net remaining costs within the terminal after crediting all terminal concession and other non-airline terminal revenues against the total operating and capital costs of the terminal. Under a residual approach, the airlines assume the risk of the residual terminal costs and are responsible for guaranteeing the airport terminal operates on a financial break-even basis. After crediting all non-airline terminal revenues to the total terminal requirement to derive the net terminal requirement, a residual methodology uses a leased airline space divisor. As such, 100 percent of the net remaining terminal costs are spread among the airlines leasing space within the terminal, and the airport operator does not assume the risk of any vacant airline space.

Table 5 presents a basic example of the traditional terminal rental rate approaches.

Based on the basic examples presented in Table 5, the commercial compensatory approach (rentable divisor) resulted in the highest airline rental rate. Alternatively, the compensatory approach (useable divisor) generated the lowest terminal rental rate, while the residual approach (leased divisor) produced a rate between the two. While this is typically the result one might expect from each of the three traditional methodologies, it is not always the case. Depending on a number of factors and relationships, including the relative ratios of useable, rentable, airline leased, and airline vacant space within the terminal, and the amount of non-airline terminal revenues, the rental rates produced by each methodology can vary.

11.2 Equalized versus Differential Terminal Rental Rates

At airports having a single terminal building, there is generally one average terminal rental rate calculated for the entire terminal. In the case of an airport with two separate terminal buildings, or even two different concourses, however, the airport may choose to establish either “equalized” rates or “differential” rates between the two terminal buildings or concourses. (It is important to note that this is different than establishing “weighted” terminal rental rates based on the type of airline space being leased, which is covered in Section 11.3).

For the purposes of this discussion, the following sections provide definitions of both equalized and differential terminal rental rates:

- **Equalized Terminal Rental Rates**

At an airport with two or more unit terminals or concourses, equalized terminal rental rates are being used when the overall average terminal rental rate being charged to the airlines is equal (on a per square foot basis) regardless of what terminal or concourse they may be located in and what the cost differential of those terminals or concourses may be. In this case, the sin-

²⁷While not the standard approach, there are circumstances where the divisor may be “rented” or “leased,” rather than rentable or leasable due to specific circumstances at a particular airport.

Table 5. Example of terminal rental rate methodologies.

	Compensatory Approach (Useable Divisor)	Commercial Compensatory Approach (Rentable Divisor)	Residual Approach (Leased Divisor)
Total Terminal Requirement	\$1,100,000	\$1,100,000	\$1,100,000
Less: Other Airline Reimbursables ¹	100,000	100,000	100,000
Less: Non-airline Terminal Revenues	n/a	n/a	\$500,000
Net Terminal Requirement	\$1,000,000	\$1,000,000	\$500,000
Terminal Space Divisor (square feet)	135,000	70,000	50,000
Terminal Rental Rate per square foot	\$7.41	\$14.29	\$10.00
Airline Leased Space (square feet)	50,000	50,000	50,000
Airport Space Vacancy Risk	16.7%	16.7%	0.0%
Total Airline Rent	\$370,370	\$714,286	\$500,000
<u>Example Terminal Space (square feet)</u>			
Leased Airline	50,000		
Vacant Airline	10,000		
Total Airline	60,000		
Concessions	9,000		
Other Rentable	1,000		
Total Rentable	70,000		
Public	50,000		
TSA/Security	5,000		
Airport Administrative	10,000		
Total Useable	135,000		
Mechanical/Electrical	10,000		
Voids	5,000		
Total Terminal	150,000		

- ¹ Includes airline revenues that are being reimbursed from the airlines for costs that are already included in the total airline requirement. Examples include payments for airline equipment such as flight information displays and baggage system equipment.

Source: Ricondo & Associates, Inc., May 2009.

Prepared by: Ricondo & Associates, Inc., May 2009.

gle equalized rate for all airlines is generally calculated by totaling operating expenses, capital costs, and other terminal costs associated with all terminals or concourses and dividing by the appropriate square footage divisor for all terminals or concourses. As a result, all operating and maintenance costs, as well as capital costs, are spread equally to all airlines.

- **Differential Terminal Rental Rates**

At an airport with two or more unit terminals or concourses, differential terminal rental rates exist when an airport operator charges different terminal rental rates to airlines operating at each unit terminal or concourse. In the case of differential terminal rates, terminal costs (i.e., operating expenses, debt service) are accumulated and accounted for separately for each specific terminal. The rental rate for each terminal is then calculated by dividing each respective terminal's costs by the appropriate square footage divisor for each terminal.

Traditionally, differential terminal rental rates have evolved at airports where different unit terminals or concourses have been constructed at different points in time for substantially different

costs. For example, an airport operator that originally constructed a unit terminal building in 1980 may decide that to accommodate anticipated growth in passengers it now needs to construct a new additional unit terminal. Due to inflationary impacts, however, the second additional unit terminal now costs several hundred million dollars more than the original unit terminal. In an effort not to burden the airlines still located in the older unit terminal with the costs of the newer unit terminal, the airport and the airlines may choose to assess differential terminal rental rates to the airlines operating in the old terminal versus those operating in the new terminal. In addition to this example, there are several other instances that differential rates may evolve from including the following:

- Domestic versus international terminal buildings
- Terminal facilities being constructed primarily for the benefit and at the request of one airline
- Terminal facilities having large differences in operating expenses
- Terminal facilities having large differences in capital costs

Complications surrounding equalized versus differential rates during airline negotiations generally arise from two areas: equality issues among airlines (e.g., costs and age of facilities) and the use of other funding sources, particularly PFCs.

The issue of equalized versus differential terminal rental rates typically is influenced by who is driving the need for new terminal facilities, the airport operator or the airlines, and which airlines are benefitting from the new facilities (or conversely, which airlines may be benefitting from the cheaper facilities). Depending on the circumstances, a number of equality issues can surface. Those airlines to be located within the new terminal facilities would probably prefer equalized rates for all terminals to benefit from an overall lower average rental rate. Alternatively, those airlines expected to remain in the older terminal facilities would likely favor differential rates, so they can benefit from lower rates for the older facilities. In the case where differential rates are considered, airlines may also request to be located within the older terminal to benefit from lower rates, causing issues with how to divide up the terminal space among the airlines. However, the airport operator may prefer to use equalized rates so as not to negatively burden certain airlines with higher costs than others. All these factors must be weighed when considering equalized or differential terminal rental rates.

- Compliance with PFC Assurances

The other issue that can surface with differential terminal rental rates is with the FAA's PFC Assurances. Appendix A of 14 Code of Federal Regulations (CFR) Part 158 contains a list of Assurances that must be complied with in the conduct of a project funded with PFC revenue, in particular, Assurances 8(b) and 8(c). As documented in the FAA's *Passenger Facility Charge Audit Guide for Public Agencies*:

"Assurance 8(c) was intended to prevent the use of PFC funds to construct a terminal facility that would be leased exclusively or preferentially to an air carrier at a greatly reduced rate (due to Assurance 8(b)) from that paid for comparable facilities used by other carriers. The carrier using the PFC-built facility would be required by Assurance 8(c) to pay a rent equivalent to the one paid for a comparable non-PFC facility, even if this rent leads to a higher payment than would otherwise be permitted by Assurance 8(b). Compliance can be achieved by increasing the rent of the PFC financed facilities to the rate for equivalent non-PFC financed facilities (rate equalization), reducing the rent of the non-PFC financed facilities (rent reduction), or a combination of both. With regard to Assurance 8(c), any rate differential between two terminal facilities at an airport should not be the result of the use of PFC funds at one terminal and not the other. Thus, in the case of a rent higher than permitted by Assurance 8(b), the public agency must demonstrate that the higher rent is needed to establish comparable rental rates for facilities in accordance with Assurance 8(c).²⁸"

²⁸Passenger Facility Charge Audit Guide For Public Agencies, Federal Aviation Administration, Passenger Facility Charge Branch, APP-530, Revised September 2000.

Table 6. Example of weighted terminal rental rates.

Airline Space Type	Average Terminal Rental Rate	Weighting Factor	Weighted Terminal Rental Rate
Type I - Ticket Counter	\$40.00	1.50	\$60.00
Type II – Holdroom	\$40.00	1.25	\$50.00
Type III - Baggage Claim	\$40.00	1.00	\$40.00
Type IV - Bag Makeup	\$40.00	0.75	\$30.00

Source: Ricondo & Associates, Inc., May 2009.

Prepared by: Ricondo & Associates, Inc., May 2009.

11.3 Weighted Rental Rates

At its most basic level, airport operators simply charge an airline based on the average rental rate per square foot across all types of airline space. In other words, the airlines are charged the same rate per square foot, regardless of the type of space they occupy (i.e., ticket counter, baggage claim, holdrooms, bag makeup). Alternatively, airport operators use weighted terminal rental rates, whereby the average terminal rate at an airport is multiplied by a factor to calculate different rates for each type of airline space.

Table 6 presents an example of how an airport's terminal rental rates may be weighted by type of airline space.

The more visible or premium airline space, such as ticket counters and hold rooms, are typically given a higher weighting factor than other airline space that is less visible or more readily available such as baggage claim or bag makeup space. There are a number of reasons that the airport operator or airlines may want to consider weighted terminal rates, for example:

- From an airport operator standpoint, it may want to consider implementing weighted rates to prevent the airlines from leasing more space than they may need, particularly premium space such as ticket counters.
- From an airline standpoint, it may prefer weighted terminal rates so it can consider taking more non-premium space for its operations or offices at lower rates.

Alternatively, an airport operator may prefer not to employ weighted terminal rates in an effort to simplify its rates and charges calculations, accounting system, and invoicing requirements.

CHAPTER 12

Joint Use Formulas

12.1 Background

Joint use and common use facilities refer to facilities that are used by more than one airline for a similar purpose. Because more than one tenant uses these facilities the cost of the facilities should not be born by a single airline. Consequently, airport operators have had to develop a methodology to fairly distribute the cost of joint use facilities among the users.

When airport operators began developing Agreements that focused on specific methods for developing rates, fees, and charges, the inbound baggage equipment and associated areas were the areas most often used by more than one airline. While gates may also be joint use facilities, the majority of airline gates were initially leased on an exclusive basis. Over time, airport operators began making some gates available on both a preferential and a shared use basis and formulas have also been developed for these facilities. Joint use facilities may be used by more than one airline simultaneously or, depending on activity schedules, may be used on an individual basis by an airline at certain times of the day.

Joint use formulas were developed to recognize the significant capital investment required for baggage claim devices, belts, and motors as well as the size of the areas needed and to gain an airline's commitment to the market. A method of sharing the relatively high investment cost among the multiple users of the facility was necessary. Joint use formulas for gate areas may differ from formulas used for baggage claim areas for two main reasons: (1) only a subset of the airlines serving the airport may use the joint use gates and (2) while the overall finish of airline gates is usually completed at a higher level of finish than baggage claim areas, the level of capital investment for these facilities is usually less than the baggage claim areas.

Usually, a formula is developed and the cost of a portion of the facility is prorated among the users on one particular basis while the remaining cost is prorated among the users on a different basis. In the case of baggage claim areas, the initial formulas were based on the philosophy that all users should make an equal commitment to the investment in the facility and the remaining portion of the cost would be shared on the basis of use of the facility and equipment. In recent years, airport operators have expressed concerns about the financial impacts of the equal commitment portion of joint use formulas, especially on the smaller market share carriers. This has contributed to the increased focus on the activity portion of the formula.

Several different joint use formulas exist, but regardless of the formula used, airport operators recover the full cost of the facility. Thus, airport operators may not have as strong an opinion on which formula is used as the airlines might, as long as the airport operator feels it is fair and equitable.

Impacts on both airport operators and airlines are discussed in the following sections; however, the issue is somewhat philosophical in nature, and there is not necessarily a right or wrong approach.

12.2 Impact on and Importance to Airport Operators

Airport operators will recover the full cost of the joint use facilities so the importance to an airport operator generally centers on the cost for new entrants that want to test the market. In addition to offering facilities at an affordable cost, airport operators also want the cost to be shared fairly, but at the same time recognize that the operating philosophies of network airlines and LCCs are different and the success of each airline's operation at the airport is dependent on its operating margin.

While usually not of significant importance, if all else is equal, airport operators may prefer a formula that incurs the least administrative burden for calculation and invoicing purposes. A complex formula can delay billing and receipt of revenue.

12.3 Impact on and Importance to Airlines

Airline views on this topic vary greatly and it is unusual to obtain unanimity on a particular formula. Each formula has a different monetary effect on each airline depending on the circumstances of the particular airport. Airlines with large enplanement shares may seek a formula with the greatest percentage of the total cost as possible split between all users on an equal basis to gain a financial advantage. At the other end of the spectrum, airlines with a limited market share may seek a formula that recognizes its limited use of the facility.

If the airport is a hub airport for an airline, the hub airline will have a strong preference for a joint use formula for use of baggage claim facilities to require all airlines to contribute on an equal basis to as large a share of the total cost as possible because a hub airline's connecting passengers do not use the baggage claim facilities, yet usually it is the airline's total enplanement count that is included in the formula. In a few airports, the hub airline has been successful in excluding its connecting passengers from inclusion in baggage claim joint use formulas.

12.4 Various Alternatives for Treatment in Agreements

Both the airport operator and the airlines will need to understand and evaluate the situation at a particular airport to decide what type of formula to support. The traditional and probably the most prevalent formula is known as an "80/20 formula." There can be variations, but the following list represents the most prevalent formulas used for baggage claim facilities:

- 80/20 formula, wherein 80 percent of the total cost of the facilities is prorated among all the airlines based on their percentage of enplaned passengers, even though it is deplaning passengers that use these facilities. The number of enplaned passengers has been an easily obtainable statistic for airport operators to audit and it is accepted that in most cases an enplaning passenger does return and becomes a deplaning passenger. Thus, enplanements and deplanements are roughly equal. The remaining 20 percent of the cost of the facility is shared equally amongst the number of airlines using the facility.

- 90/10 formula, wherein 90 percent of the total cost of the facilities is prorated among all the airlines based on their percentage of enplaned passengers. The remaining 10 percent of the cost of the facility is shared equally amongst the number of airlines using the facility.
- 100 percent enplanement, where the total cost of the facility is prorated amongst the airlines using the facility based on their percentage of enplaned passengers.
- Either the 80/20 formula or 90/10 formula with a stipulation that airlines having an enplanement market share below a specified small percentage pay a fixed fee per passenger, determined by the airport operator and credited against the total cost that is being split by the other airlines that are subject to the joint use formula.

Typical joint use formulas for gate facilities include the following:

- 80/20 formula, with 80 percent of the cost being charged based on a per passenger basis for the passengers using the gate(s) and 20 percent of the cost is shared equally among the airlines using the gate(s).
- 50/50 formula, where 50 percent of the total cost is prorated based on the number of each airline's aircraft departures at the gate(s) and 50 percent is prorated on the number of enplaned passengers using the gate(s).
- 100 percent enplanement, where the total cost of the gate(s) is prorated on the number of enplaned passengers using the gate(s).

12.5 Linkages to Other Agreement Provisions

- Affiliates—whether an affiliate is treated as part of the signatory airline and, therefore, does or does not participate in any joint use formula as a user (i.e., is the airline, its enplanements, and its operations contained in the signatory airline's count?) (see Chapter 13).
- Facility control—what airport facilities are joint use facilities (see Chapter 9).
- Terminal rate methodologies—how the joint use formula is integrated into the terminal rates and charges structure (see Chapter 11).

Affiliates

13.1 Background

Historically, an airline was required to execute an Agreement to be considered a signatory airline at that airport. Then, as “network” or “legacy” airlines began to develop relationships with other airlines in the form of code-sharing, some Agreements allowed for these code-sharing airlines to receive the same rights and privileges as the airline executing the Agreement. However, not all Agreements permitted this expansion of rights and privileges. While some airport operators accepted these relationships, others still required an airline to execute an Agreement to receive the rights and privileges of signatory status.

In recent years, some Agreements have allowed for an expansion of this definition—generally termed as “affiliates” or “affiliated airlines.” For example, a network airline that maintains a relationship with a regional airline may be willing to designate that airline as an affiliate for that airline to receive signatory rights and privileges. This can include wholly owned subsidiaries, a parent company of an airline, and an airline that operates under the same trade name as the signatory airline and essentially uses the same livery as the signatory airline.

After the introduction of LCCs to the industry, and especially after LCCs began to serve more markets and their respective market shares at those airports increased over the past decade, a greater awareness was created and there was concern by the LCCs that through the granting of signatory airline rights and privileges to an expanded group of airlines, the individual rights and privileges of an LCC could be diminished. This was exacerbated by the fact that LCCs historically did not have regional affiliate relationships with other airlines. In addition, LCCs took issue that while these affiliates were granted signatory rights and privileges, they were not necessarily required to commit to leasing space in the terminal over the term of the Agreement. From the network airlines’ perspective, however, operating through a relationship with another airline was a normal part of their business model, and was nothing more than using other aircraft types while not being required to actually purchase or lease such aircraft.

The impacts to both airport operators and airlines are discussed in the following sections; however, the issue of affiliates is more philosophical in nature, and there is not necessarily a right or wrong approach.

13.2 Impact on and Importance to Airport Operators

Airport operators need to determine their objectives concerning airline commitment to the market (executing the Agreement and leasing space in the terminal during the Agreement term), the distribution of enplanement market share between network and LCCs, whether the airport is a hub for a network airline, and the lost revenue opportunity by granting affiliates signatory

rights and privileges. While an airport operator that has an airport residual Agreement with its signatory airlines would not experience any financial risk, there is still the distribution of the revenue requirement through the airline parties that should be fair and equitable.

For example, an airport operator must recognize the cost and operating implications to the network airlines serving the airport if that airport is a hub for that network airline, representing a large percentage of the traffic at that airport. If primarily an O&D airport, the airport operator will need to consider the distribution of market share between network airlines and LCCs at that airport. While a residual Agreement would not produce any financial risk or exposure for the airport, a compensatory Agreement would, depending on how broadly affiliates are defined, but financial implications overall are generally considered marginal. An airport operator would also need to understand the accounting and administrative burden to its staff to monitor and manage affiliates at the airport. However, the accounting and administrative burden potential can be minimized at an airport if the definition of affiliate has certain restrictions and limitations and identifies the signatory airline as the sole responsible party in dealings with the airport operator.

13.3 Impact on and Importance to Airlines

The impact to airlines is not universal. There clearly is a differentiation between network airlines and LCCs. Network airlines generally will prefer a fairly broad definition of affiliate at an airport, which serves to provide greater flexibility for the signatory airline and lower overall operating costs for the combined entity. On the other hand, LCCs believe that their status is diminished, as other airlines will be receiving signatory rights and privileges, yet they are not required to make the same commitment to the market during the term of the Agreement.

How an airline (whether a network or LCC) responds to this issue will, in part, be determined by whether the airport is a hub for the network airline and the distribution of market share between those network airlines and the LCCs.

13.4 Various Alternatives for Treatment in Agreements

Recognizing that both the airport operator and the airlines will need to understand and evaluate the circumstances at that particular airport and the impact of affiliates, there are various treatments of affiliates that can be contained in an Agreement. The list ranges from a rigid requirement that a signatory airline must execute the Agreement to receive the rights and privileges of signatory status, to a fairly broad interpretation that allows affiliates to receive those rights and privileges with no commitment to leasing space during the term of the Agreement. The following represents various alternatives to address in Agreements:

- An airline must execute the Agreement for signatory status.
- A wholly owned subsidiary or the parent company of the airline is granted signatory status.
- A wholly owned subsidiary, a parent company, an airline operating under the same trade name or that essentially uses the same livery as the signatory airline are granted signatory status.
- For Agreements with the broader definition of affiliates, provisions can also include “signatory airline must notify the airport operator which airlines will be that airline’s affiliates; and the signatory airline will be responsible for the payment of the affiliates’ rentals, fees, and charges.”
- Some Agreements will further limit affiliate participation at an airport to just the same level of rentals, fees, and charges as the signatory airline, but affiliates would be excluded from any revenue sharing calculated for signatory airlines at that airport.

13.5 Linkages to Other Agreement Provisions

- Capital project control and consultation—whether an affiliate has the right to participate in MII discussions (see Chapter 8).
- Joint use formulas—how an affiliate’s passengers are treated for purposes of calculating the joint use requirement (see Chapter 12).
- Signatory status—further delineation of signatory status at airports (see Chapter 10).
- Airline rates, fees and charges—whether or not affiliates may be granted signatory airline rates and charges (see Section 2.3 and Chapter 11).

CHAPTER 14

Airport Financial Liquidity and Debt Service Coverage

14.1 Background

By their nature, airports are capital intensive enterprises. Airport Council International–North America’s (ACI–NA) 2009 capital needs survey identifies approximately \$94.3 billion in projects at domestic airports through 2013. Of this amount, 30% (\$28.3 billion) is expected to be financed through GARBs.²⁹ As the ACI–NA survey does not distinguish between PFC and CFC revenues used for debt service and direct payment for projects (pay-as-you-go), the actual amount of projects financed through various forms of debt is likely higher, and may approach 50 percent of the total project costs.

Given the importance of external financing to the development of the nation’s airport infrastructure, airport operators seek to preserve their access to the bond market at the lowest possible borrowing costs by maintaining the highest possible bond ratings. The credit quality of airports is bolstered by the airports’ importance to the overall structure of the national economy, the limited competition between facilities in local markets, and the high barriers to entry into the airport industry. These factors provide the basis for the sector’s strong investment-grade ratings, which are further supported by the lack of a default by a major domestic commercial airport.

Despite these inherent strengths, as the aviation industry has evolved over the 30-year period following the deregulation of the airline industry in 1978, the financial liquidity and level of debt service coverage generated by airports have become increasingly important measures of credit quality by the rating agencies and the investment community. Developments during this period that raised the profile of liquidity and coverage include (1) increased volatility in enplanement activity and the growing importance of passenger-related revenues such as PFCs, parking, and concessions to an airport’s overall financial structure; (2) the intense competitive position and weakened financial performance of the domestic airlines and resultant bankruptcies of numerous airlines; (3) the activity shocks experienced after September 11, 2001, and the outbreak of Severe Acute Respiratory Syndrome (SARS); and (4) the acceptance of greater levels of financial risk by airport operators through the use of compensatory/hybrid rate-setting methodologies and the shorter terms of Agreements.

The increased focus on liquidity and coverage metrics is noticeable in the commentary put forth by the rating agencies in their published research. In its airport rating criteria Fitch states the following:

“An important part of Fitch’s analysis focuses on unrestricted liquidity, defined as cash and marketable investments available to airport management for any legal and lawful purpose. Fitch views positively airports that generate and accumulate significant surplus revenues since a strong liquidity position gives an

²⁹ACI–NA, “Airport Capital Development Costs 2009–2013,” February 2009.

airport greater security in the near term in the event that a tenant airline fails to meet its financial obligations. Airports can also use these surplus funds to internally finance capital improvements and potentially lower the debt burden passed on to airlines or passengers . . .³⁰

Moody's is more specific about the environment of 2009, a period of declining economic activity, reduced demand for air service, and contraction in the operations of the domestic airlines. Moody's states in its *2009 U.S. Airport Sector Outlook* that "Airports that were able to develop robust operating margins and build substantial financial liquidity as the airlines expanded in recent years are well positioned with the financial flexibility to manage the current contraction in airline service." Moody's indicates that a level of enplanement volatility over time is anticipated in its ratings and that "The debt service coverage margins and liquidity expected at certain rating levels during normal growth periods allow for a moderate decline in airport activity and operating revenue without resulting in rating action."³¹

14.2 Impact on and Importance to Airport Operators

As a result of the importance of an airport to the economic well-being of its underlying service area, and the extensive capital planning requirements related to maintenance and improvements to the facility, airport operators take a long-term approach to the financial and physical operations of an airport enterprise. This approach takes into account the need for airport management to maintain the financial flexibility to support strong credit ratings to maintain cost-efficient access to the capital resources available in the municipal bond market.

The rate-setting mechanism employed at an airport plays a significant role in determining the internal liquidity and debt service coverage generated at an airport. Residual-based airports tend to have less unrestricted cash on their balance sheet and a coverage ratio nearer the rate covenant than a compensatory/hybrid-based airport. In the residual setting, the airlines hold the financial resources on their balance sheet in return for assuming the financial risk of the airport. This generally results in lower airport costs passed along to the airlines during periods of economic expansion. However, in times of economic weakness, this mechanism generally results in higher costs passed along to the airlines to compensate for reduced non-airline resources—a point in time at which airlines are particularly sensitive to rising airport rates and charges.

The compensatory/hybrid model generally allows airport operators to generate higher levels of internal liquidity and debt service coverage by incentivizing their management to maximize non-airline related revenues such as parking and concessions. While compensatory-based airline rates may be marginally higher relative to residual rates during periods of economic expansion, the presence of financial reserves should allow an airport operator to absorb the effects of a moderate economic downturn without turning to the airlines for significant increases in their rates and charges.

Moody's fiscal year 2007 U.S. Airport Medians demonstrate the difference in liquidity and coverage levels between the two rate-setting methodologies in terms of liquidity and debt service coverage. Moody's found the median level for unrestricted cash at residual-based airports equaled 354 days of expenditures in fiscal year 2007, compared with a median of 394 days at compensatory/hybrid-based airports. Median debt service coverage provided by net revenues, as measured on a bond ordinance-defined basis equaled 1.61 times annual debt service for residual airports, compared with 2.19 times for compensatory/hybrid facilities.

³⁰Fitch Ratings handbook.

³¹Moody's 2009 rating outlook.

While compensatory/hybrid-based airport operators have assumed a greater financial risk, with the ability to hold significant financial resources to mute the effects of underlying economic volatility, many such airport operators maintain an extraordinary coverage provision in their Agreements to protect against an unexpected decline in their financial position. These provisions allow an airport operator to recover resources from the airlines sufficient to meet the rate covenant contained in their bond ordinance/indenture through a special adjustment to their rates and charges, providing bondholders assurance of debt service payments in periods of significant financial distress. However, as in the residual model, an airport operator is likely to invoke this clause at a time of economic distress when airlines are also under financial pressure and sensitive to increases in their rates and charges.

With the increased number of airline bankruptcies, airports have also become more insistent that airlines post performance deposits to protect themselves against a sudden change in a particular airline's financial position. These deposits typically range from 2 to 6 months of estimated rates and charges due. The deposits may take the form of a cash escrow, surety bond, or letter of credit. Airports should be aware that in certain instances a cash escrow may be considered the possession of an airline in a bankruptcy and therefore inaccessible to the airport in such a circumstance. Therefore, a surety bond or a letter of credit may be preferred for this purpose. Airports have also become diligent in collecting receivables in a timely fashion to both ensure their liquidity position and protect against a large pre-petition debt in case of an airline bankruptcy filing.

14.3 Impact on and Importance to Airlines

As the prime users of these capital intensive facilities, airlines benefit from the strong credit position of airports in the long term through their lower cost of capital, which translates into lower rates and charges. However, airlines have become focused on their short-term financial operations as a result of the extreme economic cyclicalities and resultant financial distress the airline industry has experienced in the last 20 years. This short-term focus places tension on the airport-airline relationship, as airlines seek to maintain as much liquidity as possible on their balance sheets to manage through cyclical swings and limit future commitments to airport CIPs to control long-term costs.

Airlines tend to view the high liquidity levels of airports as a cost because significant reserves can be an inefficient use of resources compared with the higher returns generated through other applications. Particularly in times of economic stress, airlines may seek to have the airport operator reduce its reserves to lower rates and charges, thus reducing the short-term operating costs of the airlines.

Airlines also tend to view deposit requirements as placing costs on their operations, either through the reservation of an airline's cash resources or the expense of maintaining a surety bond or letter of credit. From the airlines' view, shortened aging of payables may be viewed as another restriction on their cash resources because this limits their ability to "play the float" and generate investment earnings.

14.4 Various Alternatives for Treatment in Agreements

In general, the amount of net revenue an airport operator must legally generate in a given fiscal year to support its general airport revenue bonds is pursuant to a rate covenant established pursuant to its bond indenture. Agreements are generally subordinate to bond indentures. While the airport operator and the signatory airlines may negotiate a certain rate-making approach, it must at a minimum meet the rate covenant obligations set forth in the bond indenture.

Additional financial liquidity is extremely dependent on factors such as the underlying airport market, its planned uses for such liquidity, and the type of rate-making methodology. Airport operators with a residual-type rate-making approach generally have less flexibility in creating additional liquidity and tend to have less unrestricted cash on their balance sheet and a coverage ratio nearer the rate covenant compared with a compensatory/hybrid-based airport. Airport operators that employ a compensatory/hybrid model may have the inherent ability to generate higher levels of internal liquidity and debt service coverage due to higher levels of non-airline related revenues such as parking and concessions.

The inclusion of certain other “non-cash” items in airline rates and charges such as debt service coverage or amortization can also impact an airport operator’s ability to meet its rate covenant or generate internal liquidity. An airport operator must at a minimum meet its rate covenant obligations and including these items in rates and charges may be necessary. However, the inclusion of these items in airline rates and charges is a function of need and negotiations between the two parties.

14.5 Linkages to Other Agreement Provisions

- Airline rates, fees, and charges—types of methodologies (see Section 2.3 and Chapter 11).

PART IV

WHERE DO WE GO FROM HERE?

Potential Future Provisions and Issues

The aviation industry is a very dynamic industry where conditions can change dramatically in short periods of time, and it is challenging to stay on top of how the industry may change. The only certainty regarding the future of the aviation industry is that it will change and that change will most likely be relatively significant. Therefore, it is important that business arrangements between airlines and airports allow for some flexibility to account for these changes. This chapter identifies some of the trends or events that are occurring or are considered emerging at this time and how they relate to future provisions and issues within Agreements or other business arrangements.

15.1 Airline Mergers

In recent years, there have been several major airline mergers and there is a real prospect of continuing consolidation in the airline industry. Airline mergers can have major consequences for an airport and for all the airlines that serve it. However, the impacts are difficult to predict and will vary widely depending on the nature of the combining airlines, their respective roles in the local market, and a wide variety of other circumstances. The rapidly changing complexion of the airline industry has been a major factor contributing to the desire of both airport operators and airlines to move toward short-term rather than long-term Agreements. In negotiating Agreements, airport operators may wish to maximize their ability to control the assignment and use of terminal space in the event of an airline consolidation; airlines, however, may seek to maximize their ability to combine operations and reduce costs in the event they merge during the term of an Agreement.

It is difficult to predict the future of the airline industry; however, if consolidation becomes more prevalent, airport operators and airlines should seek to be positioned for this in their Agreements. Certain issues that could arise with mergers or consolidation include termination of Agreements, assignment of terminal space, and provisions regarding affiliated airlines. It is important that Agreements clearly state the conditions that must occur for airlines to merge into one carrier (e.g., level of ownership, single operating certificate). Once these conditions have been met, it is also important to clearly indicate what the surviving airline's obligations are regarding facilities and space leased by the absorbed carrier(s). Because an Agreement typically involves a contractual relationship between the airport operator and several airlines, the potential operational and financial impacts resulting from an airline merger extend beyond just the consolidating carriers.

15.2 Airline Bankruptcies

There have been many airline bankruptcies since the airline industry was deregulated 1978. In the years following September 11, 2001, airline bankruptcies have become a frequent occurrence. As a result, it is important to keep the possibility of airline bankruptcies in mind when new

Agreements are negotiated. Airport operators are motivated to limit their potential losses and maximize their operational flexibility in the event of airline bankruptcies, and airlines are motivated to preserve their ability to reorganize quickly and adapt their operations (and legal commitments) to changing financial circumstances.

The bankruptcy of an airline can have significant business and legal implications for any airport that it serves. The following issues often arise:

- Will the airline accept or reject its lease, and when must it make its election?
- Can the airport operator reassign gates?
- What financial losses will the airport operator or other carriers be forced to absorb?
- Does the airport operator have adequate security for the airline's pre-petition debt?
- Will the airline properly remit the PFCs it has collected?

Also, the impact of airline bankruptcies can vary widely from airport to airport and airline to airline depending on the nature of the market it serves. The following issues often arise:

- Is the airport one of the bankrupt airline's hubs or is the airline serving an O&D market?
- Will the airline seek to alter its local operations significantly? (Is it downsizing?)
- What kind of Agreement is in effect? (Is it a compensatory or residual Agreement?)

The ability to collar the risks of bankruptcy through Agreements is limited because of the often preemptive effect of federal bankruptcy law.

The potential financial and operational consequences of airline bankruptcies are beyond the scope of this study. Bankruptcy law is highly technical and specialized, the rules applicable to airline bankruptcies are not all well settled, and both airport and airline negotiators should seek counsel on these matters as they consider alternative forms of Agreements. TRB has recently published a useful and detailed discussion of many of these issues. See *ACRP Legal Research Digest 6: The Impact of Airline Bankruptcies on Airports* (Transportation Research Board 2009).

15.3 Consortiums

In recent years, the industry has experimented with various organizations and structures for providing services to both airports and airlines. One of these structures is the development of consortiums. Generally, consortiums are considered in certain operating situations because it is believed that this structure is more efficient and less costly than other, more traditional approaches (e.g., airport staff, airport contracting). Other potential advantages include the ability to maintain consistent standards, provide opportunity to consolidate contracts, provide flexibility and the ability to respond quickly, and provide a local single point of contact for common operating and maintenance functions. For example, consortiums are being considered for operating in-line explosive detection system baggage handling systems, airline equipment, facilities, service contracts, and fuel systems.

Consortiums are formalized legal entities that are registered and licensed with the government. A consortium will have a defined scope and purpose; have two or more airline members; be a decision making structure; have the ability to enter into contracts; and have the ability to budget, make expenditures, and allocate and collect funds. There will be a formal legal structure identified that provides for participation of both the airlines and the airport operator. Important characteristics of a consortium are leadership, clear scope definition, and sufficient capitalization and cash management strategies.

With greater frequency, airlines and airport operators are discussing the concept of consortiums at airports. The airport operator must consider the impacts to staffing at the airport; the perception of control over day-to-day operations at the airport; the organized labor contract(s) in place at the airport; and the cost impact of a consortium versus airport staff or an outside airport contract to provide selected services. As interest in consortiums increases over the coming years, it will be important for both the airlines and the airport operators to fully discuss, evaluate, and analyze the advantages and disadvantages of the consortium approach before implementation.

15.4 Emergence of Specialty Carrier Business Models

During the 1990s, the LCC business model began taking hold in the airline industry. Airports where LCC initiated service for the first time experienced accelerated passenger growth as a new segment of demand for air travel was being created. Throughout the 1990s and into the current decade, LCCs continued to expand their share of the overall airline market, and it has become evident that this business model is here to stay. LCCs typically offer high frequency service and strive for comparatively higher rates of use of airport facilities; they often seek business terms that are tailored to accommodate their business model.

Over the last several years, a “specialty” carrier business model has emerged and has been finding its way onto the airline industry landscape. Specialty carriers (e.g., Allegiant Air, Sun Country Airlines) have been offering low-fare, low frequency service geared toward leisure passengers from smaller O&D markets into major destination/vacation markets (e.g., Orlando, Las Vegas, Cancun). This air service is generally offered on larger narrow-body aircraft, although the frequency of service is often less than daily given the level of demand at the smaller O&D markets.

These carriers generally have a relatively high level of operations at their key focus destination airports (to which they fly passengers from across the nation), but they will often have a relatively small presence at many of their origin markets, where they may not even provide daily service. This means that the traditional business arrangements between legacy carriers offering frequent service to their hubs and airport operators may not work well for specialty carriers from either an operational or a financial standpoint.

FAA Grant Assurance 22 and the 1996 Rates and Charges Policy prohibit any “unjust” discrimination between aeronautical users. That being said, specialty carriers have successfully made the case at some airports that a carrier operating small aircraft on a high frequency basis and a second carrier operating large aircraft on a low frequency basis are not similarly situated because they make different use of and have different impacts on the airport and, therefore, that they can qualify for a “just” difference in airport rates and charges. The specifics of the market and the airlines serving that market are key drivers in the formulation of reasonable business deals. Therefore, it is important for all parties to understand the market and the varying carrier business models to assist in determining the types of business arrangements that work best for that particular market.

15.5 Air Service Incentive Programs

From time-to-time, airport operators may choose to offer financial incentives to incumbent or new entrant airlines to provide new air service. These are commonly referred to as air service incentive programs. It is important to understand that there are certain legal restrictions on the types of incentives that an airport operator can offer. An air service incentive program must be consistent with the FAA’s Sponsor Grant Assurances, the FAA Rates and Charges Policy, and

the FAA Revenue Use Policy. Direct subsidy payments to airlines are forbidden; however, limited waivers of airport fees may be allowed if they are as follows:

- Temporary
- Available to all qualifying airlines on a non-discriminatory basis
- For “new airline service”
- Not paid for (through offsetting increases in other fees) by the other airlines serving the market and not participating in the air service incentive program

Given that air service incentive programs must be temporary and generally do not represent a “sustainable” business arrangement, they are often established as temporary policies by airport operators rather than formalized in Agreements.



APPENDICES A , C , and F

Appendices A, C, and F are available on the TRB website at www.TRB.org by searching for “ACRP Report 36.” Titles of the appendices are as follows:

Appendix A: Annotated Bibliography

Appendix C: CIP Primer

Appendix F: Airport Online Survey

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APPENDIX E

Glossary of Key Terms

Additional Bonds Test: A bond resolution requirement pursuant to which an airport can issue revenue bonds that have a claim on revenues which is equal to that of the already issued outstanding revenue bonds. Typically, the test is based on coverage of maximum annual debt service by historical or projected net revenues.

Affiliate: Provisions in an Agreement that establish the relationship between an airport, regional airlines and their associated mainline airlines.

Airfield: Those portions of an airport, excluding both the terminal aircraft apron and cargo aircraft apron, provided for the landing, taking off, and taxiing of aircraft.

Airline-Airport Affairs Committee (AAAC): Composed of authorized representatives of each signatory airline which meet periodically with senior representatives of airport management to receive information and provide input with regard to selected operation, financial, and development matters of the airport.

Airport/Airline Use and Lease Agreement (“Agreement”): Agreement that specifies the financial obligations, terms of use, and other responsibilities that each party assumes with respect to the use of the airport’s facilities. The Agreement sets the commencement and termination dates for the use of airport facilities, identifies the facilities to be used and the degree of use, the rate-making methodology, and defines the approved uses of the facility.

Airport Revenues: Income accrued by an airport or airport system in accordance with generally accepted accounting practices, including investment earnings, from or in connection with the ownership or operation of the airport or airport system or any part thereof, or the leasing or use thereof.

Amortization: The repayment of airport funds invested in capital projects over a defined term at an imputed interest rate.

Apron: A paved area on the airside of the terminal (or cargo) building that is designated for the parking of aircraft and support vehicles, and the loading and unloading of aircraft.

Bond Resolution: Authorizes the issuance of airport revenue bonds and assures bondholders that the airport is a viable concern, able to continue operating and to fulfill its obligation to pay bond interest and principal. The bond resolution establishes the airport’s “flow of funds” and deposit requirements.

Capital Improvement Program (CIP): An airport’s planned capital program which typically covers a 5-year period. The CIP usually includes project descriptions, estimated project costs, and funding sources such as federal grants, PFCs, and proposed bond funding.

Commercial Compensatory Methodology: Under this type of methodology for determining terminal building rental rates, the square foot divisor would comprise all airline rentable space in the terminal and all other space that is identified as rentable to non-airline tenants and users (e.g., concessions, rental cars, etc.). While not the standard approach, there are circumstances where the divisor may be “rented” or “leased,” rather than rentable or leasable due to specific circumstances at a particular airport.

Common Use Passenger Processing Systems (CUPPS): A standardized technology platform recommended by IATA (and other trade associations) that is recently being implemented by airports to enable multiple airlines and service providers the ability to share physical check-in or gate podium positions. This set of standards replaces the older Common Use Terminal Equipment standards.

Common Use Space: Non-exclusive areas of an airport used in common by airlines, along with other authorized users of the airport.

Compensatory Methodology: Under this methodology, an airport operator charges its airline tenants fees and rental charges in an amount necessary to recover the actual cost of operating and maintaining the facilities being leased and/or used by the airline parties.

Cost Centers: Those areas or functional activities of an airport or airport system used for the purposes of accounting for revenues, O&M expenses, amortization, and debt service.

Coverage: A premium in excess of the annual debt service requirement established in the rate covenant of a bond resolution designed to provide liquidity and bondholder protection in the event of a short-term decline in revenues.

Customer Facility Charge: CFCs are a charge imposed by a car rental company upon a car rental customer arriving at an airport and renting a vehicle at an airport. The CFC is collected by the car rental company generally to assist in the funding of facility development and expansion for car rental companies.

Debt Service: Any principal, interest, premium, and other fees and amounts either paid or accrued for bonds, and other accounts which may be established for payment of principal, interest, premium and other fees and amounts associated with financing instruments subordinated to the bonds.

Differential Rental Rate: A terminal rental rate methodology in which rates are calculated based on the specific investment in the space. The user of a newer space generally pays a higher rate than the user of older space.

Equalized Rental Rate: A terminal rental rate methodology in which the same rental rate is applied to all users for the same class of space regardless of the age and condition of the space.

Exclusive Use Space: An area rented to an airline for its sole use. Ticket counters, airline operational and administrative offices, and airline club rooms are commonly designated as exclusive use space in many Agreements. Exclusive use space is also typically associated with special facility leases (i.e., space built by and dedicated to one airline).

Extraordinary Coverage Protection: Payments required in the rentals, fees, and charges for signatory airlines at an airport in any fiscal year in which the amount of revenues, less O&M expenses is projected to be less than the amount required by the rate covenant in the bond resolution.

Funded Coverage: This method calculates and recovers the coverage amount each year. Any built-up amounts are generally treated by establishing a fund to support airport capital improvements or the excess funds may be split between the airport and airlines.

General Airport Revenue Bonds: Municipal bonds secured by the revenues generated by the airport (e.g., landing fees, terminal rents, concession revenues, etc.).

Hybrid Agreement: An Agreement where the terminal buildings and other cost centers are compensatory and the airfield is governed by a residual methodology. Hybrid Agreements may also include net revenue sharing.

Joint (or Common) Use Formula: A formula that allocates the cost of a space between the airlines where some portion (e.g., 0%, 10%, or 20%) is divided equally between users and the remainder (e.g., 100%, 90%, or 80%) is allocated based on activity (e.g., enplaned passengers or landed weight).

Joint Use Space: Terminal areas which may be assigned to two or more airlines.

Landing Fee: A per plane charge for use of the airfield, typically assessed based on the 1000-lb maximum gross landed weight of the aircraft.

Majority-in-Interest Clause (MII): A clause found in some Agreements that provides signatory airlines the opportunity to review and, by a prescribed percentage of airlines, approve or veto capital projects that would be funded through the airline rate base.

Negative MII: A provision found in certain Agreements whereby a proposal is approved unless a majority of the signatory airlines disapprove. Certain MII clauses assume that a non-response is an affirmative vote.

Non-Airline Revenues: All sources of airport revenue not paid by the airlines. These will include automobile parking; concessions; car rentals; other building and land rentals, etc.

Non-Signatory Airline: An airline that has not executed an Agreement with a particular airport. These airlines may pay higher rates and charges than signatory airlines in exchange for the flexibility of not having a long-term contractual commitment.

Operating Expenses (O&M Expenses): The current expenses, paid or accrued, for operation, maintenance, and ordinary current repairs of an airport or airport system. O&M expenses typically do not include any allowance for depreciation or renewals or replacements or obsolescence of capital assets, or any operating expenses of special purpose facilities buildings where the lessees are obligated to pay such operating expenses.

Ordinance Methodology: Local government legislation which specifies the terms and conditions under which airlines will operate at an airport in the absence of an Agreement. Unless challenged on the grounds of being unreasonable or unduly discriminatory, the rates and charges must be paid as stated.

Passenger Facility Charges: PFCs are imposed by public airport operators to supplement funds available from federal AIP grants to assist in airport development and expansion. They are approved by the FAA and are collected by the airlines through an addition to the price of the ticket for each enplaned passenger. PFC revenue can be used to fund only specific capital improvement projects that will preserve or enhance safety, capacity or security; reduce noise; or increase airline competition.

PFC Backed Bonds: These municipal bonds are generally of two types: (1) stand-alone PFC backed bonds secured only by PFC revenue and (2) double-barrel bonds backed by both PFCs and airport revenue.

Preferential Use Space: Space rented to an airline in which it has preferred, but not exclusive, use of the space and may be required to share the space if a certain level of activity is not maintained.

Rate Covenant: A pledge to bondholders that an airport will set rates and charges sufficient to generate net revenues (revenues less O&M expenses) equal to at least the annual debt service requirement plus the coverage requirement.

Reserve Requirements: Cushions designed to give bondholders extra security to ensure that airport will meet debt requirements. The three most common reserve requirements are (1) debt service reserves (typically one year of debt service payments); (2) O&M reserves; and (3) renewal and replacement reserves.

Residual Methodology: Under this methodology, signatory airlines agree to pay any costs of operating the airport system, airport, or a specific cost center that are not allocated to other users or covered by non-airline revenues. Signatory airlines assume the risk of overall revenue short-fall and receive the benefit from any revenue surpluses.

Revenue Sharing: Agreement provisions that indicate how surplus revenues will be split between the airport and the airlines. Revenue sharing can be cost-center specific or airport-wide depending on the Agreement.

Rolling Coverage: A one time payment of the coverage amount that is “rolled over” from year-to-year to meet the coverage requirement.

Security Deposit: A particular period of time’s rentals, fees, and charges (typically three months) that airlines are required to post by certain airport operators in accordance with their Agreement. Often there are provisions allowing the airport operator to exempt airlines from this requirement if they can show that they have promptly paid rentals, fees, and charges at similar-sized airports over a particular period of time.

Signatory Airline: An airline that executes an Agreement with a particular airport. At many airports these airlines pay lower rates and charges than non-signatory airlines. In some Agreements, signatory airlines may also be granted MII rights.

Special Facility Revenue Bonds: These municipal bonds are used to finance airport projects or improvements (e.g., terminal) that are for the benefit of a particular airline. The bonds are issued through the airport sponsor, but are backed entirely by the airline’s lease payments to use the facility. Issuance has declined since airlines have contested their lease payments on facilities backed by these bonds in bankruptcy court.

Term Sheet: An abbreviated document that outlines the material terms and conditions of a business agreement. These are generally used to formalize the specific business arrangement in an Agreement.

“Use-or-Lose Provision”: An Agreement provision applicable to preferential use gates that typically requires an airline to maintain a certain number of departures at a gate each day or else the airport is given the right to reassign the airline’s gate to another signatory airline.

Abbreviations and acronyms used without definitions in TRB publications:

AAAE	American Association of Airport Executives
AASHO	American Association of State Highway Officials
AASHTO	American Association of State Highway and Transportation Officials
ACI-NA	Airports Council International-North America
ACRP	Airport Cooperative Research Program
ADA	Americans with Disabilities Act
APTA	American Public Transportation Association
ASCE	American Society of Civil Engineers
ASME	American Society of Mechanical Engineers
ASTM	American Society for Testing and Materials
ATA	Air Transport Association
ATA	American Trucking Associations
CTAA	Community Transportation Association of America
CTBSSP	Commercial Truck and Bus Safety Synthesis Program
DHS	Department of Homeland Security
DOE	Department of Energy
EPA	Environmental Protection Agency
FAA	Federal Aviation Administration
FHWA	Federal Highway Administration
FMCSA	Federal Motor Carrier Safety Administration
FRA	Federal Railroad Administration
FTA	Federal Transit Administration
HMCRP	Hazardous Materials Cooperative Research Program
IEEE	Institute of Electrical and Electronics Engineers
ISTEA	Intermodal Surface Transportation Efficiency Act of 1991
ITE	Institute of Transportation Engineers
NASA	National Aeronautics and Space Administration
NASAO	National Association of State Aviation Officials
NCFRP	National Cooperative Freight Research Program
NCHRP	National Cooperative Highway Research Program
NHTSA	National Highway Traffic Safety Administration
NTSB	National Transportation Safety Board
PHMSA	Pipeline and Hazardous Materials Safety Administration
RITA	Research and Innovative Technology Administration
SAE	Society of Automotive Engineers
SAFETEA-LU	Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users (2005)
TCRP	Transit Cooperative Research Program
TEA-21	Transportation Equity Act for the 21st Century (1998)
TRB	Transportation Research Board
TSA	Transportation Security Administration
U.S.DOT	United States Department of Transportation

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